

II. System of Quality Management

Implementation of Operation of Quality Management

Outline

The CPAAOB inspects whether measures developed by audit firms to ensure adequate operations and maintenance/enhancement of the System of Quality Management (SQM) are appropriate to the size and characteristics of the firm.

Responses to requirements for SQM under the audit standards vary from large-sized audit firms with several thousand members to relatively small-sized audit firms. Furthermore, many deficiencies identified thus far reflect the size and characteristics of each audit firm, and the background to the deficiency as well.

Therefore, in “II. System of Quality Management”, examples of deficiencies identified in the CPAAOB inspections are categorized into “Large-sized audit firms” and “Mid-tier, and small and medium-sized audit firms”.

Note that the examples of identified deficiencies include ones that could occur at any audit firm regardless of its size. Therefore, when examining SQM in your firm, please also refer to examples of deficiencies in the categories other than your firm belongs.

(Revision of Quality Control Standards Concerning Audits)

The revised Quality Control Standards have been applied to audits of financial statements for fiscal years or accounting periods starting on or after July 1, 2023 (for audit firms other than large-scale audit firms under the Certified Public Accountants Act, for fiscal years or accounting periods starting on or after July 1, 2024). As practical guidelines necessary for application of the revised quality control standards in practice, QCSS No. 1 (Quality Control at Audit Firms) and ASS No. 220 (Quality Control in Audit Engagements) were revised and published in June 2022, and QCSS No. 2 (Engagement Quality Control Review) was also published, both of which were simultaneously applied to the revised Quality Control Standards. At the time of publishing this Case Report, examples of deficiencies based on the revised standards had not been identified. Therefore, QCSS No. 1 and ASS No. 220, which are cited as the basis for the deficiencies described in this Case Report, clearly state "before the revision in 2022" and present the revised standards that are considered to correspond to the basis as [Reference]. The revised standards are provided merely as reference information and do not indicate the CPAAOB's position on the interpretation or scope of the standards.

(Revision of the Code of Ethics)

The Code of Ethics was amended in July 2022, and Practical Guidance No. 1 on the Code of Ethics, "Q & A (Practical Guidance) on the Code of Ethics," was published in December 2022. As a result of the amendment of the Code of Ethics and the publication of Practical Guidance No. 1, the "Guidance on Independence," "Guidance on Conflicts of Interest," "Guidance on Responses to Illegal Acts," and "Interpretive Guidance on Professional Ethics" were abolished in March 2023.

Among the deficiencies listed in this Case Report, the provisions that are cited as the basis for deficiencies

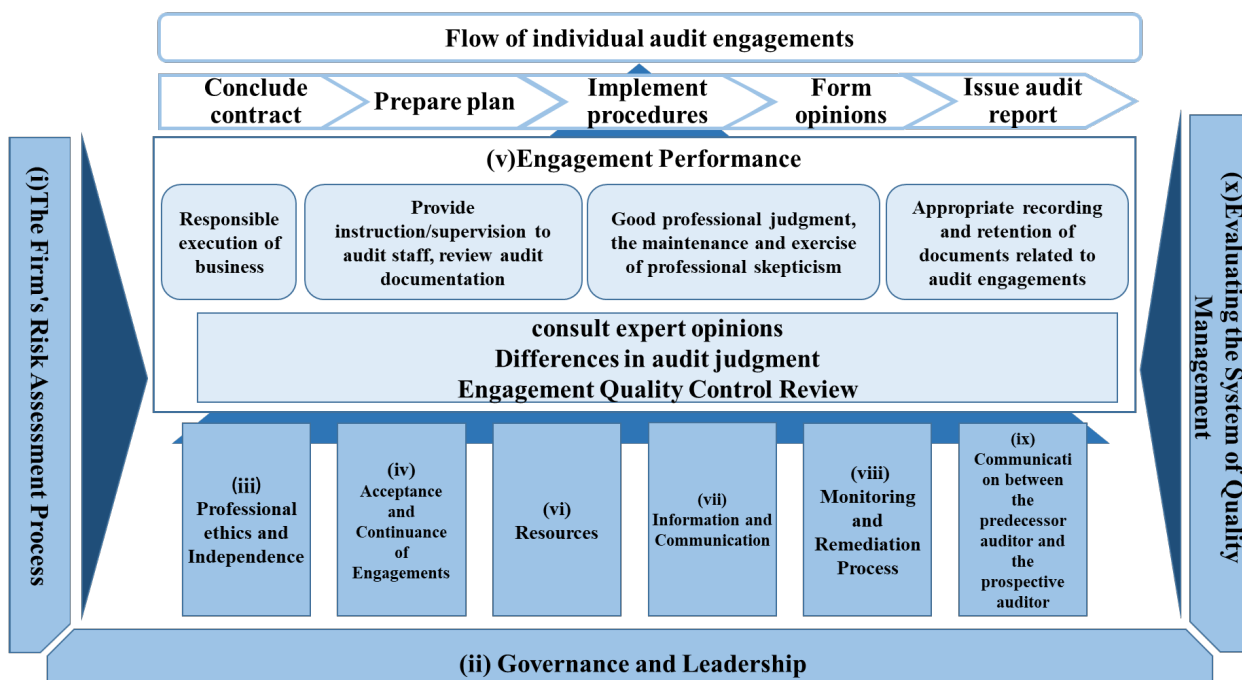
based on the pre-amendment Code of Ethics clearly state as "before the amendment in 2022" or "before the repeal in 2023," and the amended Code of Ethics corresponding to the provisions that served as the basis for deficiencies before the amendment are listed as reference information based on the old / new correspondence table published by the JICPA.

Relationship between quality control system and individual audit engagements

Regardless of the size of an audit firm, the purpose of establishing and operating a quality control system is to reasonably ensure the quality of audit engagements as an organization. The quality control system required is stipulated in the "Quality Control Standards for Audits" and the "QCSR," etc., and it has a significant impact on the quality of individual audit engagements through the establishment and operation of a quality control system. Some audit firms have established a quality control system only as a formality. In such cases, the system does not operate as expected and thus does not function effectively in improving the quality of individual audit engagements.

The revised quality control standards define quality control system as follows: (i) The Firm's Risk Assessment Process, (ii) Governance and Leadership, (iii) Professional Ethics and Independence, (iv) Acceptance and Continuance of Engagements, (v) Engagement Performance, (vi) Resources, (vii) Information and Communication, (viii) Monitoring and Remediation Process, (ix) Communication between the predecessor auditor and the prospective auditor. The SQM of an audit firm must be evaluated at least once a year by setting a record date and conclude whether the quality control system provides the audit firm with reasonable assurance that the objectives of the system are achieved((x) Evaluating the System of Quality Management). (i) In order to enable audit firms to conduct quality control on their own initiative, audit firms are required to set quality objectives for each component of their quality control system, identify and assess quality risks that could hinder the achievement of the quality objectives, and define and implement policies or procedures to address the assessed quality risks. (ii) Governance and Leadership establish the environment underlying an audit firm's quality control system and have a significant impact on all other components of the quality control system of an audit firm. It should be noted that (ii) Governance and Leadership must also be included in the evaluation of (i) The Firm's Risk Assessment Process and (x) Evaluating the System of Quality Management. (v) Engagement Performance includes elements that have a direct impact on the quality of individual audit engagements, such as the direction and supervision of assistants by engagement partners, review of audit documentation, and review of audit engagements. The quality of individual audit engagements can be reasonably ensured when the aforementioned quality control system functions comprehensively and effectively in accordance with the scale and characteristics of each audit firm (see [Figure 2]).

[Figure 2] Image: Relationship between System of Quality Management and Individual Audit Engagements



Source: Prepared by the CPAAOB

Analysis of deficiencies that occurred

At large-sized audit firms, although deficiencies related to the design of a SQM have seldom been identified in recent years, there are still many deficiencies in individual audit engagements. Therefore, it can be assumed that there are deficiencies in the operation of the SQM. Specifically, operation-related deficiencies have been identified in areas such as reviews of audit work papers, engagement quality control reviews and periodic inspections.

Furthermore, with regard to deficiencies in individual audit engagements that were identified by the CPAAOB inspections and quality control reviews in the past, adequate verification was not conducted as to whether improvement measures had taken hold and how effective they were. As a result, the same or similar deficiencies have been identified in other individual audit engagements. In such cases, it may be deemed that efforts to improve quality control operations are insufficient.

For example, the objectives of measures designed to improve deficiencies were not fully understood by divisions and engagement teams, etc., and were not sufficiently permeated. As a result, the expected effects of improvement measures were not achieved, and similar deficiencies continued to be identified in individual audit engagements.

At Mid-tier audit firms and small and medium-sized audit firms, deficiencies have been identified in a broad range of areas in terms of both the establishment and implementation of the quality control system. In addition, same as at large-sized audit firms, inspections of individual audit engagements found cases where

deficiencies, which had been identified in the past by the CPAAOB inspections and quality control reviews, etc., were not appropriately remediated. In many of those cases, the deficiencies were deemed to be attributable to the quality control system. Specifically, there were many cases where the CEO and the PICOQC did not have sufficient awareness and knowledge of quality control operations and did not appropriately develop and operate a quality control system. There were also many cases where the CEO and the PICOQC did not have sufficient understanding of the depth and methods of cause analysis required to prevent the occurrence of similar deficiencies identified in quality control reviews, etc.

Specifically, although persons responsible for each function of the quality control system, such as EQC reviews and education / training, had been appointed, there were cases in which the deficiencies inherent in quality control and individual audit engagements had not been identified and corrected on their own due to insufficient human resources allocated to each office at the headquarters.

(Observed effective efforts)

There were cases such as the following of effective efforts having been made to strengthen the quality control of the firm as a whole:

In the area of quality control operations, a council has been established to identify the issues to be considered and integrate the administration of regional offices. This council comprises members of the quality control division at the headquarters as well as members from across the entire audit firm, including partners, managers, and senior staff involved in quality control at regional offices. Furthermore, the results of its consideration are shared with the board and partners meetings at regional offices to ensure that there is no variation in the responses over the regional offices.

Note that when such efforts are made, it is essential to pay adequate attention to their effectiveness, so it is important for the CEO and the PICOQC to actively commit.

Expected response

Based on the adequate awareness of the primary purpose of a quality control system, which is to reasonably ensure the quality of audit engagements, all audit firms are required to establish and implement such system effectively and efficiently, depending on the size and characteristics of each audit firm, so that the SQM can effectively work in individual audit engagements. Specifically, the CEO and PICOQC of audit firms should aware the purpose and importance of the quality control system, take the initiative in ensuring that whole personnel in a firm understand the primary purpose of the SQM, disseminate measures to improve the quality of audit throughout the entire organization, and verify their effects at all times. In this regard, it should be noted that the revised QC standards also state that it is important for the CEO to have an awareness of organizationally ensuring audit quality and to demonstrate leadership toward the establishment of a quality control system.

Note that the content and scope of quality control policies and procedures stipulated by an audit firm are affected by various factors, such as the size and composition of personnel at the firm, the characteristics of the management of organization, and whether the firm belongs to a global network. In light of this, the CEO

and PICOQC of audit firms should establish appropriate SQM according to the size and characteristics of their firm and appropriately maintain the system by revising it as needed.

(Reference)

Main provisions serving as the basis grounds for deficiencies identified in quality control operation and relevant points to be noted are as follows.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
1. Initiatives to Improve Operation	QCSS No. 1 paragraphs 15, 16, 31 (before the amendment in 2022)	<ul style="list-style-type: none"> ➤ For deficiencies identified in inspections, etc., has formulated and implemented specific improvement measures based on the root causes. ➤ Whether the proposed improvement measures have been disseminated throughout the organization. ➤ Whether the effects of the improvement measures have been verified.
2. Establishment/Implementation of Internal Rules and Compliance with Laws, Regulations, and Professional Standards	QCSS No. 1 paragraphs 15, 16, 17, 18 (before the amendment in 2022)	<ul style="list-style-type: none"> ➤ Whether the audit firm has developed an organizational culture that ensures compliance with laws, regulations, and professional standards as well as internal rules. ➤ Whether the audit firm periodically checks whether there are any discrepancies between the internal rules it developed and their actual implementation. ➤ Whether the audit firm has developed a control system for appropriately recording and managing the CPA qualifications and actual working hours of partners and employees. ➤ Whether the audit firm has established security rules necessary for the use of Internet server services in the course of

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		business, and whether it has considered security measures.
3. Professional Ethics and Independence	QCSS No. 1 paragraphs 20, 21, 23, 24 (before the amendment in 2022)	<ul style="list-style-type: none"> ➤ Whether the audit firm obtains confirmation letters concerning independence from all target persons at least once a year. ➤ Whether the audit firm conducts independence confirmation procedures when accepting or continuing audit engagements. ➤ Whether the audit firm has developed and implemented a control system for updating, in a timely and accurate manner, the list of regulated companies, which is necessary for the procedures to confirm. ➤ Whether the audit firm has established a policy and specific procedures concerning compliance with professional ethics, such as dependence on remuneration, restrictions on employment, confidentiality, and gift-giving and entertainment, and informed them to professional staff. ➤ Whether the audit firm has established policies and procedures to comply with the rotation system for engagement partners, etc. ➤ Whether substantive measures are implemented in complying with professional ethics, considering the purpose of the requirements set out in the Code of Ethics.

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
4. Acceptance and Continuance of Engagements	QCSS No. 1 paragraphs 25, 26(before the amendment in 2022) ASS No. 900 Paragraphs 9, 13	<ul style="list-style-type: none"> ➤ Whether specific procedures for evaluating contract risks have been established, and whether approval by the audit firm is made in a timely and appropriate manner. ➤ Whether the identified engagement risks have been appropriately reflected in the audit plans for individual audit engagements. ➤ Whether the audit firm examines whether it has sufficient human resources to implement newly accepted engagements. ➤ Whether the predecessor auditor provides information including information and circumstances relating to material misstatements in the financial statements in good faith and clearly in response to inquiries from the prospective auditor. ➤ Whether the prospective auditor makes inquiries of the predecessor auditor on matters required under auditing standards in order to determine whether or not to accept the engagement.
5. Recruitment, Education and Training; Evaluation and Assignment	QCSS No. 1 paragraphs 28, F28-2, 29, 30(before the amendment in 2022)	<ul style="list-style-type: none"> ➤ Whether the audit firm continually provides education and training aimed at improving its audit quality control capabilities, and provides follow-up to personnel who have not completed the mandatory training. ➤ Whether the audit firm has established policies and procedures to fairly evaluate the competence (especially competence related to quality control) of professional staff and their compliance with

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		<p>professional ethics with regard to evaluation, remuneration and promotion, and whether these policies and procedures are properly implemented.</p> <ul style="list-style-type: none"> ➤ Whether the engagement team sufficiently evaluates the time, work experience, and capabilities, etc. that professional staff, including engagement partners, can secure to perform their duties when forming the engagement team;
6. Audit Documentation	<p>QCSS No. 1 paragraphs 31, 44(before the amendment in 2022) ASS No. 220 Paragraphs 14, 15, 16(before the amendment in 2022)</p>	<ul style="list-style-type: none"> ➤ Whether the engagement partner reviews the audit documentation and holds discussions with the engagement team to confirm that sufficient appropriate audit evidence has been obtained to support the conclusions and audit opinion. ➤ Whether the audit firm has appropriately developed policies and procedures for the final assembly of the audit file, and ensures that the final assembly of the audit file is completed by the deadline. ➤ Whether the audit firm has adequate policies and procedures in place to ensure the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation.
7. Engagement Quality Control Review	<p>QCSS No. 1 paragraphs 36, 37, 38(before the amendment in 2022)</p>	<ul style="list-style-type: none"> ➤ Whether a person with the necessary experience and skills, etc. and who maintains objectivity and independence has been appointed as the EQC reviewer. ➤ Whether the EQC reviewer examines, based on the audit documentation, whether the evaluation of independence,

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		the necessity of consultation with experts and the conclusion reached, and the significant judgments made by the engagement team are supported by sufficient appropriate audit evidence.
8. Monitoring the Firm's Quality Control System	QCSS No. 1 paragraph 47, 48, 49, 50(before the amendment in 2022)	<ul style="list-style-type: none"> ➤ Whether the audit firm has assigned responsibility for the operation of the monitoring and remediation process to an individual with appropriate competence and capabilities, and provided that individual with the authority necessary to fulfill that responsibility. ➤ Whether the audit firm appropriately grasps the status of establishment and implementation operation of the quality control system, and has established an inspection system to identify deficiencies. ➤ Whether the audit firm has had the person in charge of periodic inspection conduct an in-depth inspection of whether the audit evidence is sufficient and appropriate, by making inquiries of the professional staff and inspecting the audit documentation. ➤ Whether at least one completed audit engagement is selected for each engagement partner in each specified period determined by the audit firm as part of periodic inspections. ➤ Whether the audit firm evaluates the impact of deficiencies identified through ongoing monitoring and periodic inspections, instructs the relevant

Item	Main provisions that serve as the basis for the Identification	Relevant Points to Note
		manager (s) to implement corrective measures, and checks the appropriateness of the measures.
9. Cooperation with Company Auditors	ASS No. 260 Paragraphs 13, 14, 15, 16, 22	<ul style="list-style-type: none"> ➤ Whether the engagement team clearly communicates with the company auditors, etc. about the auditor's responsibilities related to the audit, an overview of the scope and timing of the planned audit including the nature and the reasons of identified significant risks. ➤ Whether the engagement team provides audited companies with appropriate written explanations about the results of the CPAAOB inspections and quality control reviews. ➤ Whether important audit findings are communicated to company auditors in a timely manner. ➤ Whether the engagement team clearly communicates with the company auditors, etc. information on fees for audit engagements of public interest entities.

[Large-sized Audit Firms]

1. Efforts to Improve Operation

Points of focus

At large-sized audit firms, although a quality control environment has been developed as a formality, there may be some deficiencies in its operation. Therefore, the CPAAOB inspects, in a focused manner, whether effective, rather than a formality, efforts are being made to improve operations in response to deficiencies identified in the previous CPAAOB inspection and quality control review.

Specifically, the CPAAOB verifies the effectiveness of the firm's improvement efforts by checking the status of cause analysis of the deficiencies identified in the past and the status of the implementation of remediation based on it, and by examining individual audit engagements. In the case where issues are identified in the measures to improve operations, the CPAAOB examines the effectiveness of the remediation measures carried out by the firm through the process such as examining problems on the operation management system that are supposed to be the cause of issues.

Outline of inspection results

At large-sized audit firms, improvement measures for deficiencies identified in the CPAAOB inspections and quality control reviews are often drafted under the initiative of the quality control division etc. at the headquarters, and after being made known to each engagement team through training and notifications, each engagement team takes action, such as reviewing actual audit procedures according to the risks of each audited company. In addition, in order to further disseminate improvement measures, there is a tendency to establish a quality control environment not only at the headquarters but also at divisions closer to the audit frontline.

However, the CPAAOB inspection identified that organizational improvement measures were not necessarily sufficient at different levels within the firm, including divisions and partners. For example, cases in which cooperation between the head office and divisions was inadequate or in which efforts to make operational improvements had not sufficiently taken hold at divisions and regional offices where staff assignment is not flexible due to a lack of exchange of personnel with other divisions, etc. Furthermore, cases in which there were lacks of organizational support from the head office and audit service divisions concerning the response to the important audit areas where no significant change had occurred, were identified.

Expected response

Large-sized audit firms employ several thousand employees and have multiple offices, including regional ones. As a result, they usually have multiple divisions with several hundred employees. It is therefore important that measures taken at the headquarters are instilled throughout the entire organization as a means of improving operations. In order to achieve this, it is important to increase the

understanding of quality control operations at the firm as a whole and to take action at the firm as a whole, including division managers, rather than having only limited departments, such as the quality control department, take action. In particular, the CEO needs to take the initiative in encouraging all members, especially engagement partners who are in a position to lead each engagement team, to make operational improvements so that the purpose of operational improvements reaches the entire organization. In addition, the PICOQC needs to plan and implement timely and appropriate measures under the direction of the CEO, and division managers need not only to make operational improvements themselves, but also to provide appropriate instructions and encourage professional staff under their umbrella to take appropriate actions.

Furthermore, the CEOs and PICOQCs, together with department heads, etc., should establish an effective system to monitor improvement and promptly take appropriate remedial actions in case a problem related to the status of dissemination or effectiveness of improvement measures has been recognized as a result of verification.

In carrying out measures to improve operations at large-sized audit firms, close attention should be paid so that the measures are not superficial, such as giving uniform instructions for remediating deficiencies throughout the entire firms. For this purpose, it is important to carry out moderated and effective measures, such as fully analyzing the tendency and causes of the identified deficiencies to specify the target areas for operational improvement (for example, certain departments and subordinate offices, audit items such as accounting estimates and response to fraud, and IPO-related audits), and focusing on effective improvement measures that suit such target areas.

Case 1: Verification of the status of improvement

As one of the improvement measures in response to deficiencies identified in the external inspections, the audit firm conducted audit monitoring of important audit areas, mainly accounting estimates.

However, the division in charge of these measures did not adequately confirm whether the procedures for responding to audit risk, which had been prepared at the time of audit planning through audit monitoring, had been implemented, and the effectiveness of audit monitoring was not ensured for some audit engagements.

(QCSS No. 1, paragraphs 15 and 16(before the revision in 2022) ([Reference] QCSS No. 1, paragraph 37))

Case 2: Collection of audit risk information

Quality control division is collecting information on responses to audit risks in individual audit engagements by sending a questionnaire concerning audit risks pertaining to audited companies to engagement teams. It is also encouraging improvements in responses to risks by providing engagement teams with instructions as necessary based on the information it has collected.

However, in effect, **such collection is conducted as collecting same information throughout all audit engagements regardless of the degree of audit risk. Consequently, information**

corresponding to risks is not being collected.

(QCSS No. 1, paragraphs 15 and 16(before amendment in 2022) ([Reference] QCSS No. 1, paragraph 33))

2. Operation of the Quality Control System

Points of focus

At large-sized audit firms, although deficiencies in the design of a SQM have seldom been identified in recent years, deficiencies continue to be identified in individual audit engagements. The CPAAOB believes that the cause of these deficiencies lies in the operational aspects of the quality control system, although the form (organization and procedures) has been developed.

Therefore, the CPAAOB examines the existence of operational deficiencies of the SQM related to individual audit engagements from the perspective of whether the SQM that the audit firms established and implemented has failed to lead to ensuring and improving the audit quality that each engagement team implements, resulting in the failure to detect and prevent audit deficiencies.

Outline of inspection results

In terms of the operation of SQM, the CPAAOB has identified many deficiencies in areas such as reviews of audit work papers, EQC reviews and periodic inspections. Specifically, there were many cases where the engagement partner etc. conducting reviews, the EQC reviewer, and the person in charge of periodic inspections did not fully understand the changes in the environment surrounding the audited company and the audited company's circumstances, or the audit procedures performed by the engagement team, and therefore did not identify any deficiencies in individual audit engagements.

Causes of these deficiencies include: a disparity in awareness of audit quality and abilities related to quality control among partners, such as engagement partners and EQC reviewers; the QC department not being able to fully grasp the disparity; as a result, appropriate engagement partners and EQC reviewers were not assigned; and engagement teams not proactively taking action to ensure audit quality, such as not consulting the head office for expert opinions in a timely manner.

(Observed effective efforts)

There were cases such as the following of effective efforts having been made:

The QC partners in the audit division confirm the views of the EQC reviewers concerning risks of material misstatement with audit engagements identified during the course of audit by engagement partners, and inform quality control review headquarters of areas deemed to be high risk. Furthermore, quality control review headquarters examines audit teams' responses to risks, and demands that audit teams undergo headquarters quality control reviews as necessary. Because this process is performed twice a year on a continuous basis, quality control review headquarters is able to act promptly in addressing high-risk areas in listed-company audit engagements.

Expected response

Engagement partners need to be aware that they are responsible for directing, supervising, and guiding engagement team members so that they can perform audit engagements sufficiently and appropriately,

taking into account the abilities and experience of engagement team members, and to be proactively involved from the audit planning stage through the formation of audit opinions. Specifically, engagement partners need to accurately understand the progress of audits and important matters through appropriate direction and supervision of assistants to engagement partners in the audit process, conduct in-depth reviews of audit documentation, and confirm that sufficient appropriate audit evidence is obtained prior to expressing audit opinions.

Furthermore, the EQC reviewer needs to spend sufficient time to examine whether audit engagements are sufficiently and appropriately performed, such as by objectively evaluating audit procedures and audit evidence included in audit documentation for important matters and confirming that there are no problems with the process of forming audit opinions.

To this end, the CEO and the PICOQC need to establish an environment in which engagement partners conducting reviews and EQC reviewers can appropriately perform engagements.

Specifically, engagement partners should assign appropriate engagement partners and EQC reviewers, etc. based on an understanding of each partner's awareness of audit quality, abilities in quality control, and audit risks based on the audited company's corporate environment. For example, if deficiencies in the implementation of operational improvements attributable to engagement partners are detected, the audit firm as a whole should re-evaluate the abilities of engagement partners in quality control, appropriately allocate engagement partners based on abilities, and provide re-education to engagement partners.

Furthermore, large-sized audit firms utilize content such as electronic audit documentation that describes audit procedures and checklists used in EQC reviews and periodic inspections in order to conduct audits and related services effectively and efficiently. In addition, they have established a consultation function and a deliberation system in which difficult audit issues are discussed and advice / solutions are provided at the head office. Such systems are useful for achieving a certain level of audit quality throughout the firm, but they also reduce the awareness of engagement teams to proactively consider audit quality.

Engagement teams, including the CEO and engagement partners, need to make efforts to establish and operate a quality control system based on a full understanding of the benefits and limitations of such systems as described above.

Case 1: Supervision of audit engagements and review of audit work papers

- ① The engagement partner believed that, since there had been no significant changes in the circumstances of the audited company, it would be sufficient to carry out audit procedures similar to those of the previous fiscal year, or that appropriate procedures had been carried out by assistants to the engagement partner with sufficient experience. As a result, **the engagement partner did not give appropriate instructions to the assistants to the engagement partner regarding the audit procedures to be performed when disclosing financial statements, etc. and examining compliance with accounting standards, etc. for accounting treatment from previous fiscal years, and did not sufficiently review related audit documentation regarding the audit**

procedures performed by the assistants to the engagement partner.

(QCSS No. 1, paragraph 31(before the revision in 2022) ([Reference] QCSS No. 1, Paragraph 31)); ASS No. 220, paragraphs 14, 15 and 16 (before the revision in 2022) ([Reference] ASS 220, paragraphs 29, 30, 31, and 32))

- ② In an audit area where the engagement partners deemed the risk to be relatively low, based on their understanding of the company and business environment and their past audit experience, and in an audit area where the engagement partners were convinced from prior discussions, etc. with the audited company that there were no accounting issues, they thought that they should only confirm the correspondence between their assumption and the conclusion written in the audit work paper. Also, **they trusted their assistants to engagement partners excessively. Because of these issues, the engagement partners did not provide appropriate instructions/supervision and did not conduct reviews appropriately.**

(QCSS No. 1, paragraph 31(before the revision in 2022) ([Reference] QCSS No. 1, Paragraph 31)); ASS No. 220, paragraphs 14, 15, and 16 (before the revision in 2022) ([Reference] ASS 220, paragraphs 29, 30, 31, and 32))

《Points to Note》

The content, timing and scope of the audit work papers to be reviewed should also be suitably planned so that engagement partners, etc., appropriately review the audit work papers.

- ① The EQC reviewer was convinced that the engagement team had appropriately developed the audit plan based on a sufficient understanding of the audited company's business, and **lacked awareness of critically examining the audit plan developed by the engagement team from an objective standpoint.**

As a result, EQC reviewers failed to point out deficiencies concerning procedures related to response to fraud risks in their reviews.

(QCSS No. 1, paragraphs 36, 37(before the revision in 2022) ([Reference] QCSS No. 2, Paragraph 25); ASS No. 220, paragraphs 19 and 20)

- ② **The quality control headquarters did not re-examine the eligibility of the EQC reviewer according to the risks of audit engagements in which material risk information was newly identified in the middle of the fiscal year.**

(QCSS No. 1, paragraph 38 (before the revision in 2022) ([Reference] QCSS No. 2, paragraph 18))



- ③ The EQC reviewer did not find any unreasonable points in the explanations from the engagement with regard to significant judgments and conclusions regarding significant accounting estimates, etc. As a result, the EQC reviewer **did not have sufficient awareness of conducting a sufficient**

review from the viewpoint of whether the engagement team had considered and reached a conclusion in accordance with applicable accounting standards, etc.

As a result, the EQC reviewer did not sufficiently examine whether the engagement team had considered and reached a conclusion in accordance with applicable accounting standards, etc.

(QCSS No. 1, paragraphs 36 and 37 (before the revision in 2022) ([Reference] QCSCS No. 2, paragraph25), ASS No. 220, paragraphs 19 and 20 (before the revision in 2022))

Case 3: Effectiveness of periodic inspections

①The personnel in charge of periodic inspections were **not aware of the need to include areas with a relatively high risk of material misstatements in the scope of inspection**, taking into account the areas the engagement team identified as priority audit items when determining the scope of inspection. In addition, the personnel were **not aware of the need to perform a critical inspection** of the engagement team's judgment on the items included in the scope of inspection and the audit procedures performed. As a result, the personnel in charge of periodic inspections were not able to identify any deficiencies related to the examination of accounting treatment associated with the application of the accounting standard for revenue recognition or the audit of accounting estimates. (QCSS No. 1, paragraph 47(before the revision in 2022) ([Reference]QCSS No. 1, Paragraphs 37, 38, and 39))

②**Although** persons in charge for periodic inspections **confirmed the existence of audit work papers corresponding to a checklist, they lacked awareness of the need to conduct in-depth reviews concerning the adequacy of further audit procedures performed by engagement teams**. Because of this, they failed to conduct effective inspections. For example, deficiencies concerning accounting estimates and related-party transactions were not discovered. (QCSS No. 1, paragraph 47(before the revision in 2022) ([Reference] QSCSS No. 1, paragraphs 37, 38, and 39))

《Points to Note》

With regard to EQC reviews and periodic inspections, it should be noted that, as with reviews, it is necessary to objectively evaluate whether the explanations provided by the engagement team are supported by sufficient appropriate audit evidence, not only through oral communication but also through examination of audit documentation.

In addition, audit firms that position global reviews as the center of periodic inspections should check whether the global reviews exhaustively carry out inspections that correspond to the requirements under Japanese audit standards, and whether it is necessary to take any supplementary measures if there is a concern that they are not carrying out such inspections.

Case 4: Misstatements concerning qualifications as a certified public accountant in materials submitted outside of the firm;

- ① The audit firm submitted to some audited companies audit contracts, audit planning statements, and audit results statements containing misstatements that persons engaged in audits of those companies who were not registered as CPAs engaged were represented as CPAs.

In addition, **the audit firm submitted an audit summary to the Director-General of the competent Local Finance Bureau containing an excessive number of CPAs or engagement hours.**

Furthermore, the audit firm provided incorrect information to an audited company concerning the number of CPAs that should be included in the "Composition of assistants to engagement partners" column of the securities report, and as a result, **the audited company overstated the number of CPAs in the securities report.**

(QCSS No. 1, paragraph 15(before the revision in 2022) ([Reference] QCSS No. 1, paragraph 19); ASS No. 220, paragraph 7 (before the revision in 2022) ([Reference] ASS No.220, paragraph13); Article 5, Paragraph 1 of the Cabinet Office Ordinance on Audit Certification of Financial Statements, etc.)

- ② We have issued business cards indicating that they are CPAs to persons who have passed the final test but have not yet been registered as CPAs or who have not passed the final test.

(QCSS No. 1, Paragraph 1(before the revision in 2022) ([Reference] QCSS No. 1, Paragraph 19)5; ASS No. 220, paragraph 7 (before the revision in 2022) ([Reference] ASS 220, No. 13); Article 48 of the Certified Public Accountants Act).

Case 5: Omission of registration of audited company information (large companies, etc.)

The audit firm's internal rules stipulate that audit and attestation services pertaining to entities with high social impact (hereinafter referred to as "PIEs") and entities equivalent to PIEs need to undergo additional EQC reviews. Furthermore, with regard to whether an audited company falls under a large company, etc., the audit firm manages this matter through a database that contains registration information of large companies, etc. and financial information of the audited company, including capital and total liabilities. The audit firm instructs each engagement team to enter and update this database at regular intervals every year. However, with regard to audit services pertaining to an unlisted audited company that is a 100% subsidiary of a listed audited company, the engagement partner overlooked the fact that the audited company was not registered as a large company, etc. in the database even though the audited company met the requirements for a large company, etc. In addition, the engagement partner did not undergo additional EQC reviews prescribed in the internal rules. In addition, the audit firm did not take sufficient measures necessary to prevent errors in data input into the database and the failure to register the audited company as a large company, etc., and failed to detect the failure to register the audited company

as a large company, etc., in a timely manner.

(QCSS No. 1, paragraphs 15 and 34(before the revision in 2022) ([Reference] QCSS No. 1, paragraphs 19, 26, and 34); ASS No. 220, paragraph 7(before revision in 2022) ([Reference] Article 220, Paragraph 13)).

《Points to Note》

Whether or not an audited company falls under a PIE has wide-ranging effects, such as having an impact on the maximum period of involvement of the partners in charge of audit engagements, etc. and on the scope of communication with company auditors, etc. Therefore, audit firms need to establish a control environment that prevents errors.

Case 6: Communication with company auditors, etc.

①A component auditor of an audited company who belongs to the same network as the audit firm provided audit and non-audit services to the component of the audited company.

However, the assistants to engagement partner lacked understanding of the audit standards, while engagement partners did not sufficiently review the summary report of the audit results submitted to the Audit & Supervisory Board. As a result, information on fees related to those services was not provided in writing to the audited company's Audit & Supervisory Board Members.

(ASS No. 260, paragraphs 15 and 18)

②After issuing the Companies Act audit report, the engagement team explained the audit results of the Companies Act audits to the company auditors, etc. of the audited company.) The team explained the content of the draft of the management confirmation letter concerning the Companies Act audits. The team also explained the audit results again before issuing the Financial Instruments and Exchange Act audit report. b) The team explained the information on the fees paid to the audited company group for audit and non-audit services. However, the engagement team did not communicate with the company auditors, etc. regarding a) and b) above at the right time before issuing the Companies Act audit report.

(ASS No.260, paragraphs 14, 15 and 20)

《Points to Note》

Please refer to the Auditing Standards (ASS No.260, etc.), which specifically describe matters required to be communicated with company auditors, etc.

Case 7: Information Management

The audit firm has prescribed in its internal rules, etc. the appropriate handling of personal information, including that of customers and employees of business partner companies. These internal rules, etc. prescribe that personal information obtained from audited companies should be

deleted, blacked out, or otherwise handled when preparing audit documentation, except in cases where personal identification is required. However, most of the individual audit engagements subject to inspection by the CPAAOB involve audit documentation for which no measures, such as deletion or blackening, have been taken with respect to personally identifiable information. As a result, the audit firm **has not been thorough in handling personal information protection.**

(QCSS No. 1, paragraph 45 (before the revision in 2022) ([Reference] QCSS No. 1, paragraph 31), ASS No.220, paragraph 7 (before the revision in 2022) ([Reference] ASS No.220, paragraph 13)

[Mid-tier Audit Firms and Small and Medium-sized Audit Firms]

1. Efforts to Remediation

Points of Focus

In principle, CPAAOB inspections are conducted based on reports of QC reviews conducted by JICPA. Such inspections focus on the remediation of deficiencies identified in previous CPAAOB inspections or QC reviews. Specifically, CPAAOB ascertains the status of root cause analysis performed in respect of previously identified deficiencies, as well as the firm's remedial actions and other responses based on the results of such analysis. In addition, CPAAOB assesses the effectiveness of the audit firm's remediation efforts through the inspection of individual audit engagements. Furthermore, where deficiencies are identified in the firm's remediation efforts, CPAAOB endeavors to identify issues relating to the firm's system of quality management that underline such deficiencies.

Outline of Inspection Results

As illustrated by the cases described below, at some audit firms, initiatives to remediate deficiencies identified through QC reviews were not sufficiently implemented, and in respect of multiple deficiencies, remediation measures were either not implemented or were insufficient.

Possible causes of such situations include the following:

- Although PICOQC or equivalent recognized the need to analyze the underlying causes of matters noted in recommendations for improvement, their analysis was limited to direct and specific causes. As a result, they did not sufficiently understand either the necessity of, or the methodologies for, analyzing root causes within the firm's system of quality management, including governance and leadership;
- The audit firm lacked a firm-wide approach to improving audit engagements as a whole;
- The audit firm had not established a system to effectively monitor the remediation of deficiencies; and
- The divisions responsible for implementing remediation measures had insufficient personnel commensurate with the size of the audit firm.

In addition, many cases were observed in which engagement partners responsible for the review of audit documentation, EQC reviewers, and individuals in charge of periodic inspections completed their work by conducting superficial reviews of audit documentation and formalistic completion of checklists, without sufficiently understanding the purpose of their respective roles. Furthermore, audit firms often left the acquisition of audit-related knowledge and skills to the discretion of individual engagement team members, and did not proactively take responsibility for maintaining and enhancing the competence, capabilities, and suitability of audit personnel. As a result, engagement teams frequently did not sufficiently understand the level of procedures required under applicable auditing standards, such as the Audit Standards Statements. Consequently, in many cases,

the same or similar deficiencies inherent in individual audit engagements were not identified, and appropriate remediation was not implemented.

(Observed Effective Efforts)

The following are examples of effective efforts:

- The establishment of a cross-organizational project aimed at improving audit quality, led by the CEO.
- The CEO’s direct review and confirmation of the status of remediation of identified deficiencies across all audit engagements;
- Monitoring of audit documentation by partners responsible for quality control prior to the issuance of audit opinion.
- The establishment of a system enabling the early identification of audit issues, including the introduction of a preliminary EQC review process;
- Through discussions within each engagement team, identified deficiencies were analyzed, and remediation measures were communicated and implemented; and
- The establishment of a framework under which expert committees were formed for individual subject matters, in which members (including audit staff) conducted root cause analyses and discussed remediation measures, with the results of such discussions feeding back to the firm’s quality control function.

Expected Response

Audit firms are required to fully understand the scope and nature of deficiencies that require remediation, taking into account the rationale underlying the deficiencies identified through CPAAOB inspections, QC reviews, and other relevant processes. Based on such understanding, audit firms should develop and implement specific and appropriate remediation measures to address the identified deficiencies. In this regard, it is essential that the CEO exercise strong leadership. At the stage of formulating remediation measures, the audit firm should analyze the root causes of the deficiencies and design effective remediation measures aimed at addressing those causes, rather than merely addressing deficiencies on a formalistic basis. At the implementation stage, the audit firm should ensure that the content of the remediation measures is correctly understood and appropriately applied throughout the organization. In addition, audit firms should verify whether the same or similar deficiencies exist not only in the individual audit engagements in which the deficiencies were identified, but also in other audit engagements. Audit firms should also thoroughly evaluate whether the remediation measures they have formulated are being properly implemented in practice. Through such efforts, audit firms are expected to achieve improvements in audit quality on a firm-wide basis.

Case 1: Establishment and Implementation of Specific Procedures for Improvement

- ① The audit firm identified the causes of the deficiencies noted in the QC review as:

- a) insufficient understanding of audit standards;
- b) insufficient understanding of the level of procedures required by auditing standards;
- c) a lack of professional skepticism.

However, the audit firm **did not perform an analysis of the root causes** that led to the occurrence of the matters described in a) to c).

(QCSS No. 1, paragraphs 15 and 16(Before amendment in 2022) ([Reference]QCSS No. 1, paragraph 41))

- ② With regard to the root causes of the deficiencies identified in the CPAAOB inspection, the audit firm identified insufficient involvement of engagement partners in audit work. In response, the firm implemented remediation measures under which engagement partners, taking the lead, discussed and assessed audit risks within engagement teams. In addition, the quality control division confirmed, through periodic inspections and other procedures, the extent to which such remediation measures had been implemented. Furthermore, the CEO continuously communicated the importance of engagement partners' involvement in audit work through opportunities for communication with firm personnel.

However, **the quality control division lacked sufficient personnel** to continue and embed these remediation measures on a firm-wide basis. As a result, **the remediation actions taken in response to the identified deficiencies were insufficient.** In addition, **engagement partners placed excessive reliance on the formats of audit documentation revised in response to QC reviews, and their awareness of the importance of their involvement in audit work did not improve sufficiently.**

(QCSS No. 1, paragraphs 31, A30, and A31(Prior to the revision in 2022) ([Reference] QCSS No. 1, paragraphs 42 and 43), ASS No.220 (prior to the revision in 2022), paragraph 14, 15, and 16 ([Reference] No. 29 and No. 32))

Case 2: Dissemination of Specific Policies and Procedures for Remediation

The PICOQC did not sufficiently ensure the through dissemination of specific policies and procedures for remediation. For example, while the PICOQC reflected deficiencies identified in the QC review and the firm's remediation plans in the checklist used for periodic inspections, the PICOQC **did not explain to firm personnel the underlying causes of the deficiencies or the purpose of the remediation plans. In addition, with respect to part-time staff, the PICOQC merely sent documents describing the deficiencies by postal mail, and did not otherwise ensure that such policies and procedures were adequately communicated and understood.**

(QCSS No. 1, paragraphs 15 and 16) (prior to the 2022 revision) ([Reference] QCSS No. 1, Paragraphs 42 and 43))

Case 3: Verification of Remediation Status

- ① In connection with a merger, the audit firm conducted meetings with those responsible for quality management at the audit firm to be merged with and reviewed the results of inspections conducted by CPAAOB, with the aim of understanding the status of the audit firm's system of quality management.

However, although the PICOQC recognized that the audit firm to be merged with had been subject to numerous findings of deficiencies through CPAAOB inspections and other reviews, **the PICOQC did not sufficiently evaluate whether the quality of that audit firm was acceptable.**

In particular, the PICOQC did not specifically identify or analyze the nature or underlying causes of the identified deficiencies.

(QCSS No. 1, paragraphs 15 and 16(prior to the 2022 revision) ([Reference] QCSS No. 1, paragraphs 41))

- ② The audit firm communicated points to be noted in audit performance, which were based on deficiencies identified through external inspections, to staff in the firm through training programs. In addition, the firm also prepared a "Deficiencies Response Table" that listed the identified deficiencies, required engagement partners to perform self-inspections based on that table, and had EQC reviewers confirm the results of such self-inspections. However, the engagement partners and the EQC **reviewer merely confirmed the items listed in the Deficiencies Response Table on a formalistic basis and did not perform in-depth consideration as to whether such deficiencies existed.**

Furthermore, the audit firm limited these self-inspections to audit engagements for specific fiscal year-ends, and **did not perform self-inspections for audit engagements related to the other fiscal year-ends.**

(QCSS No. 1, paragraphs 15 and 16(prior to the 2022 revision) ([Reference] QCSS No. 1, paragraphs 42 and 43))



- ③ When reviewing the status of the implementation of self-inspections performed by the engagement team and the EQC reviewers, the PICOQC merely confirmed, on a formalistic basis, that items on the self-inspection checklists had been marked as completed. The PICOQC did not verify whether engagement partners had conducted self-inspections that were effective in remediating deficiencies in audit engagements, nor whether the EQC reviewers had performed in-depth reviews that appropriately reflected the purpose of remediation.

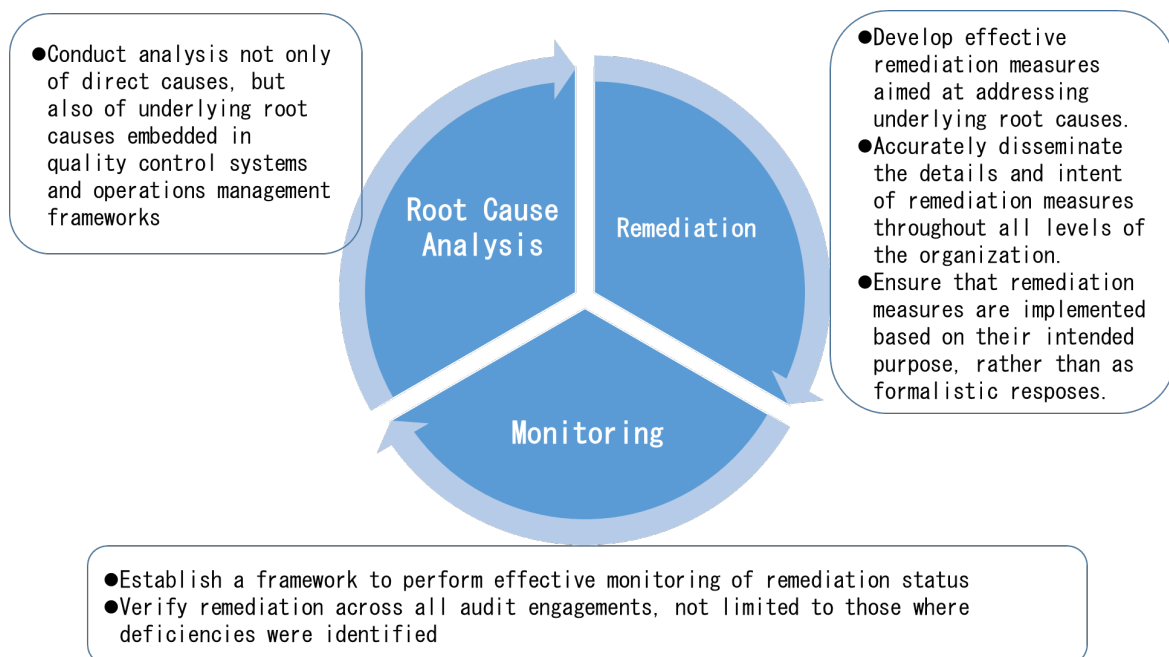
(QCSS No. 1, paragraph 15 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 43))

《Points to Note》

The above cases illustrate situations observed at audit firms where deficiencies identical or similar to those identified in past CPAAOB inspections and QC reviews were again identified. Such situations arose from the implementation of formalistic remediation measures, such as merely communicating identified

deficiencies or using remediation checklists, without identifying the underlying root causes of the deficiencies or taking effective actions to address and remediate those causes. Accordingly, the PICOQC should note that it is necessary not only to communicate the details of identified deficiencies to engagement teams, but also to consider and provide specific instructions aimed at remediating deficiencies in audit procedures. In addition, where remediation checklists or similar tools are used, the PICOQC and engagement partners should monitor the status of remediation by taking into account the rationale underlying the identified deficiencies and the scope of audit procedures that require remediation. (Refer to [Figure 3])

[Figure 3] Efforts to Remediation



Source: Prepared by the CPAAOB

2. Design, Implementation and Operation of Internal Rules and Compliance with Laws, Regulations, and Professional Standards

(1) Design, Implementation and Operation of Internal Rules

Points of Focus

CPAAOB inspects audit firms with respect to the status of design, implementation, dissemination, and operation of internal rules from the following perspectives:

- ▶ Whether the audit firm has designed and implemented internal rules that reasonably ensure audit quality, taking into sufficient consideration the size and operations of the audit firm;
- ▶ Whether the audit firm endeavors to ensure the adequacy of its internal rules, for example, by sufficiently confirming consistency among rules when designing or revising them, and by revising internal rules as necessary in response to amendments to laws, regulations, and professional standards;
- ▶ Whether the PICOQC or equivalent appropriately communicates internal rules to personnel (including part-time personnel) and ensures their thorough dissemination, for example, by providing oral explanations as necessary; and
- ▶ Whether PICOQC or equivalent verifies the status of compliance with internal rules, for example, by timely understanding and evaluating personnel's compliance with such rules.

Outline of Inspection Results

With respect to the design, implementation, and operation of internal rules, as illustrated by the cases described below, there were audit firms in which deficiencies were observed not only in the operation of internal rules but also in their design and implementation.

As possible causes of such deficiencies, there were cases in which audit firms had an insufficient understanding of the laws, regulations, and professional standards applicable to audit firms; cases in which audit firms adopted, without modification to reflect their actual circumstances, the template of "Audit Quality Management Rules" provided by the JICPA; and cases in which audit firms considered that revisions to rules were unnecessary because no issues had arisen in the past.

(Observed Effective Efforts)

The following is an example of observed effective efforts by an audit firm.

The audit firm promoted understanding of the relationship between the audit manual and the ASS by annotating each provision of the audit manual with the relevant requirements of the applicable ASS. Using such an audit manual, the audit firm provided education to personnel on the level of audit responses required by the ASS.

Expected Response

Audit firms should re-examine whether their internal rules are appropriately designed and implemented in compliance with applicable laws, regulations, and professional standards, and whether such rules are suitable in light of the size and actual circumstances of the audit firm, and should revise such internal rules as necessary. In addition, audit firms are required to establish an operations management framework that supports the appropriate design, implementation, dissemination, and operation of internal rules, for example by developing workflows that appropriately reflect actual business practices, and by ensuring the personnel understand and comply with such internal rules on an ongoing basis.

Case 1: Design of Internal Rules (Articles of Incorporation and Organizational Rules)

The CEO considered that there had been no issues in the firm's operations since the audit firm underwent a merger in the past, and therefore **did not examine whether it was necessary to redesign internal rules or review whether the existing provisions appropriately reflected the size and actual circumstances** of the audit firm. As a result, with respect to matters subject to deliberation and resolution at the general meeting of partners, the articles of incorporation merely stipulated "important matters pertaining to the operations of the audit firm," without providing specific examples or guidelines as to what constitutes such "important matters" in internal rules or other documents.

Furthermore, the audit firm had not established any organizational rules, and therefore had not specified the relationships among quality management-related functions, including the quality control function and the engagement quality review function, nor had it defined the purposes, roles, positioning, or other key aspects of important committees or meetings.

(QCSS No. 1, paragraphs 17 and 18 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19))

Case 2: Design of Internal Rules (Partners' Meeting)

The audit firm has established a partners' meeting, consisting of all partners, as a body for making decisions on important matters relating to management and operations.

However, the audit firm had not established appropriate internal rules or arrangements for the proper operation of the partners' meeting. For example, **the audit firm did not formally stipulate in writing the matters to be resolved by the partners' meeting or the methods of resolution. In addition, the audit firm did not retain records of the deliberation process or the content of resolutions, even with respect to matters purported to have been resolved by the partners' meeting.**

(Article 34-13 of the Certified Public Accountants Act)

Case 3: Dissemination of Internal Rules

The audit firm stipulated in its quality control regulations that the PICOQC is required to document policies and procedures relating to quality management in such regulations, distribute the regulations to personnel, and explain, at the time of new employment and upon the adoption or revision of such regulations, their content, the objectives to be achieved, and the fact that each individual bears responsibility for audit quality.

However, the audit firm merely kept various internal rules, including quality control regulations, in a cabinet within its office, and the PICOQC did not distribute the quality control regulations to personnel. In addition, the PICOQC did not sufficiently communicate to personnel the content of the quality control regulations or the objectives to be achieved, either at the time of new employment or when such regulations were newly established or revised. (QCSS No. 1, paragraphs 15 and 16 (prior to the in 2022 revision) ([Reference] QCSS No. 1, paragraph 19))

Case 4: Operation of Internal Rules (Retirement Age Rules)

An audit firm stipulated in its retirement age regulation that the retirement age for partners is 65.

However, with respect to partners who had reached or exceeded the retirement age, the audit firm permitted them to attend partners' meeting and maintained their registration as partners without adopting any resolution to extend the retirement age. As a result, the audit firm did not treat such partners in accordance with the retirement age regulation.

(QCSS No. 1, paragraph 15 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19))

Case 5: Operation of Internal Rules (Seeking Expert Opinions)

The audit firm stipulated in its "Audit and Quality Control Manual" that, when seeking expert opinions, engagement teams are required to document the issues to be consulted, relevant matters at issue, and relevant facts in a prescribed form.

However, the audit firm did not establish specific procedures for obtaining expert opinions. For example, the audit firm did not specify reporting procedures to be followed when an engagement team identified matters on which an expert opinion should be sought, nor did it identify individuals inside or outside the firm from whom such expert opinion should be obtained.

(QCSS No.1, paragraph 33, F33-2 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraphs 31, F31 and 4JP))

Case 6: Operation of Internal Rules (Quality Control Regulations)



The audit firm stipulated in its "Audit Quality Control Regulations" that, when all engagement partners responsible for the audit of the same entity are replaced, important matters identified in the course of the audit, including fraud risks, must be appropriately communicated."

However, at the time of such replacement the audit firm did not communicate to the succeeding engagement partners important matters identified in the course of the audit, including fraud risks. (QCSS No. 1, paragraph F32-2 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph F31-2JP), ASS No.220 (prior to the June 2022 Revision), F14-3 ([Reference] ASS No.220, paragraph F34-3JP))

Case 7: Operation of Internal Rules (Partners' Meeting Regulations)



The audit firm stipulated in its "Partners' Meeting Regulations" that the approval of financial statements and business reports constitutes matters to be resolved by the partners' meeting.

However, the audit firm did not hold a partners' meeting to approve the financial statements and business reports in accordance with the regulations.

(QCSS No. 1, paragraphs 15 and 16 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19))

《Points to Note》

In addition to the cases described above, the following deficiencies were identified:

- **The audit firm had not established an appropriate channel to receive information related to fraud risks from external parties, nor had it defined specific mechanisms for responding to such information.**
- **The audit firm had not established a system for aggregating and managing personnel working hours, which serve as a basis for audit planning and other audit-related processes.**
- **With respect to audit strategies that obtain audit evidence solely through substantive procedures without performing tests of controls, the audit manual did not set out guidelines regarding the conditions for applying such strategies, or the nature, timing, and extent of the substantive procedures to be performed.**
- **When entering into contracts for non-audit services, the audit firm did not perform the procedures prescribed in its internal rules, such as notification to all partners and deliberation thereon.**

As the templates provided by JICPA and other relevant bodies have become more comprehensive, deficiencies in the design of internal rules, such as the absence of such rules, have been decreasing. However, there continue to be cases in which audit firms adopt such templates without modification, resulting in internal rules that do not reflect the actual circumstances of the audit firm and do not function effectively in practice. Accordingly, audit firms should note the importance of periodically assessing whether there are any discrepancies between their internal rules and their actual operational practices.

(2) Compliance with Laws, Regulations, and Professional Standards

Points of Focus

Under the Act and other applicable laws, regulations, and professional standards, various restrictions and obligations are imposed on CPAs and audit firms from the perspective of ensuring the

appropriateness of their operations. Accordingly, CPAAOB inspects the status of compliance with relevant laws, regulations, and professional standards, as well as the status of the design, implementation, and operation of operations management frameworks intended to ensure such compliance.

Outline of Inspection Results

From the perspective of compliance with laws, regulations, and professional standards, deficiencies were observed in areas such as internal rules designed to ensure compliance with restrictions on competition among partners, the rotation of key personnel in charge of audit engagements, inappropriate responses to inspections, and false statements concerning CPA qualifications.

Possible causes of these deficiencies include instances in which the PICOQC or equivalent did not have a sufficient understanding of the applicable laws, regulations, and professional standards, as well as cases in which audit firms did not clearly and specifically define the responsible personnel or workflows for the tasks that require verification of compliance with laws, regulations, and professional standards.

Expected Response

Audit firms should remain mindful at all times of the mission and responsibilities of CPAs and foster an organizational culture that promotes compliance with laws, regulations, and professional standards. In addition, audit firms should identify operations for which verification of compliance with laws, regulations, and professional standards is required, designate personnel responsible for carrying out such verification, and establish appropriate operations management frameworks to ensure compliance with such requirements.

Case 1: Prohibition on Competitive Activities by Partners

A certain partner affiliated with the audit firm had continuously provided services falling within the scope of the audit firm's engagements, including audit services, at their own audit office since before becoming a partner of the audit firm, thereby violating the Act, which prohibits partners from engaging in competitive activities. In addition, the audit firm overlooked the fact that this partner was in violation of the Act.

(Article 34-14, paragraph 2 of the Act; QCSS No. 1, paragraph 19 (prior to the 2022 revision)
([Reference] QCSS No. 1, paragraph 29)

Case 2: Rotation of Key Engagement Team Members

With respect to long-term involvement in audit engagements, the audit firm's quality control regulations require that key engagement team members (namely, engagement partners, EQC reviewers, and other individuals who make important decisions or judgments regarding significant matters of audit engagement) be rotated after 7 years for audit engagements for "large companies, etc." as defined under the Act, and after 10 years for audit engagements of entities other than "large

companies, etc."

However, the CEO, who concurrently serves as the PICOQC, lacked a sufficient understanding of laws and regulations relating to independence. **As a result, in circumstances where a partner engaged in audit engagements for “large companies, etc.” as an assistant to the engagement partner had been involved for an equivalent or longer period than the engagement partner, the CEO/PICOQC did not consider whether such partner fell within the category of other individuals who make important decisions or judgments regarding significant matters of audit engagements.** In addition, some engagement partners deviated from the firm's policy on long-term involvement in audit engagements for entities other than “large companies, etc.” by continuing their involvement for more than 10 years.

(Article 24-3 of the Act; Article 9, paragraph 3 of the Ordinance for Enforcement of the Act; Guideline for Independence, Part 1, paragraph 139 (prior to abolition in 2023) ([Reference] Ethics Rule R524.6), QualityQualityQualityQualityQualityQualityQualityQCSSQuality No. 1, paragraph 24 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

Case 3: Inappropriate Responses to Inspections

The audit firm submitted the inspection-related documentation to inspectors as inspection materials without disclosing the fact that certain partners and personnel had prepared quality management-related documents after the inspection cut-off date, or had retroactively prepared audit documentation and inserted such documentation into audit files that had already been finalized and assembled.

(Articles 26, 28-3, and 34-14-3 of the Act)

Case 4: Responses to QC reviews

The PICOQC of the audit firm made statements to partners and personnel **that could reasonably be interpreted as encouraging or permitting the addition, modification and updating** of audit documentation relating to audit engagements subject to JICPA QC reviews during the period after the audit report date and before the completion of the assembly of the final engagement files.

(QCSS No. 1, paragraphs 17, and A4(prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 28)).

Case 5: Input of Working Hours by Personnel

Personnel at the audit firm were required to input working hours into the attendance management system.

However, numerous cases were identified in which the working hours of personnel, including those on statutory holidays, were not input into the attendance management system. In addition, there were multiple cases where the hours recorded in audit summary documents were understated, as well as cases where working hours on statutory holidays were recorded as working hours on regular

business days. Despite these issues, the audit firm did not implement **corrective measures to ensure the accuracy of recorded working hours across personnel as a whole, and appropriate management of personnel working hours was not achieved.**

(QCSS No. 1, paragraph 15; (Prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19), ASS No.220, paragraph 7 (prior to the 2022 revision) ([Reference] ASS No.220, paragraph 13); Article 5, paragraph 1 of the Cabinet Office Ordinance on Audit Certification of Financial Statements, etc.)

Case 6: Conflict-of-Interest Transactions



The representative partner of the audit firm concurrently served as the representative partner of a tax accounting firm, and the audit firm entrusted accounting and other services to that tax accounting firm.

However, the audit firm sought to entrust accounting services and other services to the tax accounting firm, the representative partner did not obtain the approval of a majority of partners other than the representative partner, as required under the main clause of Article 595, paragraph 1, item 1 of the Companies Act, which is applied mutatis mutandis pursuant to Article 34-22, paragraph 1 of the Act, despite the fact that such entrustment constituted a conflict-of-interest transaction.

(Article 34-13 and 34-22, paragraph 1 of the Act; Article 595, paragraph 1 of the Companies Act)

《Points to Note》

In addition to the cases described above, the following deficiencies have also been identified:

- **The requirement that a majority of partners have been engaged in audit and attestation services for 3 years or more after being registered as a CPA was not met.**
- **The audit firm had not established internal rules setting forth procedures for identifying whether services that compete with the audit firm were being conducted, nor had it specified concrete approval procedures relating to such competitive activities.**
- **There is a discrepancy between the purpose of the audit firm as stated in the Articles of Incorporation and the actual scope of the audit firm's business activities.**
- **Notification of amendments to the Articles of Incorporation was not submitted within the statutory filing deadline.**
- **The audit firm did not obtain the required approval for transactions involving conflicts of interest.**
- **The audit firm did not aggregate or manage the actual working hours of partners and other personnel, and did not establish an appropriate framework for preparing audit summary documents.**
- **Approval procedures were not conducted for contracts relating to services outsourced by affiliated companies of the audit firm.**
- **The audit firm submitted audit planning documents to certain audited entities containing false statements indicating that individuals engaged in the audits, who were not registered as CPAs, were**

qualified as CPAs.

- **The audit firm issued business cards indicating that an individual was a CPA to persons whose registration as certified public accountants had not been completed.**

(3) Information Security

Points of Focus

Firm personnel routinely obtain confidential information of audited entities and carry personal computers on which such information is stored. They also use e-mail for business communications with persons in charge at audited entities and store electronic audit documentation, as well as electronic data prior to documentation, at audit firms and on external servers. Accordingly, audit firms are required to establish and operate information security systems that appropriately address risks associated with the IT environment.

In consideration of the above, CPAAOB inspects audit firms with respect to the status of the establishment and operation of information security systems from the following perspectives:

- ▶ Whether the audit firm properly assesses information leakage risks, for example, by analyzing the types of information held by the audit firm;
- ▶ Whether the audit firm has established and operates security policies and other internal information security rules appropriate to such risks; and
- ▶ Whether the individuals responsible for information security ensure compliance with internal information security rules, for example, by continually monitoring whether personnel (including part-time personnel) comply with such rules.

Outline of Inspection Results

As illustrated by the case example below, deficiencies were identified, including failures to appropriately implement measures to prevent information leakage; failures to establish rules governing the use of internet-based server services for business operations; failures to appropriately apply security rules to part-time staff; and failures to appropriately anonymize personal information contained in audit documentation.

Causes of the identified deficiencies include the following:

The individual responsible for information security or equivalent established internal information security rules only on a formal basis and left their operation entirely to staff (including part-time staff) who use personal computers and other information devices;

The individual responsible for information security or equivalent, being overly confident that staff comply with internal rules, did not implement measures to monitor the actual status of operation of such rules at the audit firm;

- The individual responsible for information security did not adequately understand their

responsibilities and failed to establish rules suited to the actual use of information devices at the audit firm;

- Personal information was not anonymized as required;

Those responsible for information security did not sufficiently understand or recognize the importance of information security and therefore failed to recognize the necessity of appropriately establishing an information security management system.

(Observed Effective Efforts)

The following are examples of observed effective efforts by audit firms.

To mitigate the risk of information leakage resulting from the loss of personal computers, an audit firm introduced a virtual desktop infrastructure (VDI) using thin-client terminals and utilized an external cloud storage service for exchanging data with audited entities by creating individual dedicated sites accessible only by engagement team members and the audited entities. When introducing the external cloud storage service, the audit firm identified risks associated with its adoption and implemented additional management measures, as necessary, to address risks not covered by the service provider.

Expected Response

Although opportunities to obtain large volumes of electronic data have increased due to the digitization of confidential information of audited entities, many deficiencies in information security continue to be identified. Audit firms should fully recognize that information leakage may have serious adverse effects on the operation of the firm and should establish and operate appropriate information security systems in line with the actual usage of information devices at each audit firm.

In addition, data leakage resulting from unauthorized external access or cyberattacks aimed at causing system failures constitutes a significant management risk for audit firms. Accordingly, audit firms should ensure that cybersecurity measures are strengthened in accordance with advances in information technology.

Case 1: Appointment of Security Officers and Personnel



The audit firm stipulated in its Basic **Policy** Information**Policy on** Security Policy that it should appoint an information security officer responsible for information management on a firm-wide basis, as well as information security personnel responsible for the audit firm's information systems and for each audit engagement.

However, **contrary to the provisions of the Basic Information Security Policy, the audit firm had not appointed any information security officer or information security personnel.**

(QCSS No. 1, paragraph 15 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19), ASB Practical Guideline No. 5, paragraph 11)

Case 2: Design and Operation of Internal Information Security Rules

The information security officer of the audit firm did not sufficiently understand the required level or scope of information security measures and therefore established security policies and other internal information security rules, and conducted reviews of the implementation of such measures, only on a formal basis. As a result, the following deficiencies were observed:

- Although security policies were established to prevent information leakage, no policies or procedures were established regarding actions to be taken in the event of information leakage;
- Data held by the audit firm were not classified according to their level of importance, backup or encryption of stored data was not implemented, and user IDs and passwords were not assigned to personnel when accessing important electronic data;
- Although the audit firm required all partners and other personnel to submit a “Security Policy Compliance Status Report,” some partners and other personnel failed to submit such reports; and
- The audit firm did not sufficiently disseminate internal rules, including the Basic Information Security Policy, to partners and other personnel, nor did it conduct periodic education or training on information security.

(Article 27 of the Act; QCSS No. 1, paragraphs 15 and 16 (prior to the 2022 revision); QCSS No. 1 Practical Guidelines No. 1 sections III-1, IV-2, and IV-5 (prior to the 2023 revision))

Case 3: Operation of Internal Information Security Rules for Part-Time Personnel

The PICOQC stipulated in the “Information Security Regulations” that, when part-time personnel use their personal computers for audit engagements, it must be confirmed that no audit engagement data remains on such personal computers.

However, the PICOQC **merely reviewed the “Information Security Checklist” on a formal basis** and did not actually confirm whether audit engagement data remained on the personal computers.

(Article 27 of the Act; QCSS No. 1, paragraphs 15 and 16 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 19), QCSS No. 1 Practical Guidelines No. 1, sections IV-2, IV-5, and V-2 (prior to the July 2023) revision)))

«Points to Note»

In addition to the cases described above, there were also cases in which audit firms used internet-based server services provided by major internet service providers as file servers, without establishing rules that clearly set out the security measures required when such services are used for business operations.

when when When when part-time personnel use their own personal computers for audit engagements and perform the same tasks as full-time personnel, and when they handle the same types of information, it should be noted that audit firms are required to implement security measures at the same level as those applied to full-time personnel.

In addition, when periodically evaluating service providers, audit firms should note the importance of assessing the status and adequacy of the service providers' security measures.

(4) Prevention of Insider Trading

Points of Focus

If a CPA, who holds the important social mission of ensuring the reliability of capital markets, engages in insider trading using insider information of an enterprise obtained in the course of their work, trust in audits performed by CPAs may be seriously undermined.

In addition, not only will the CPA involved in insider trading be held liable, but such involvement may also significantly undermine the credibility of the audit firm to which the CPA belongs. Accordingly, audit firms are required to constantly implement effective measures to prevent insider trading by their members.

In consideration of the above, CPAAOB inspects audit firms with respect to the status of the establishment and operation of insider trading prevention systems from the following perspectives:

- ▶ Whether the audit firm has established internal rules that set out effective procedures to prevent insider trading by its members and ensures that such rules are properly communicated;
- ▶ Whether the audit firm appropriately implements insider trading prevention measures stipulated in its internal rules and, where necessary, conducts monitoring measures, including verification of transactions in specified securities by its members.

Outline of Inspection Results

As illustrated in the case examples below, there were cases in which audit firms established internal rules based on the “Rules for Preventing Insider Trading” template provided by the JICPA; however, such rules were not properly implemented.

Causes of the identified deficiencies include the following:

The individual responsible for insider trading prevention or equivalent did not comprehensively understand the insider trading prevention measures required under the internal rules; and

The individual responsible for insider trading prevention or equivalent did not verify whether members were actually complying with the internal rules, due to overreliance on the assumption that members were appropriately complying with the relevant rules.

Expected Response

Audit firms should recognize that public awareness of the adverse effects of insider trading on capital markets has increased and, accordingly, should implement more effective measures to prevent such trading.

Specifically, audit firms should take appropriate actions by taking into full consideration the “Q&A Concerning Insider Trading” issued by the JICPA (September 2, 2008) and other relevant materials, re-

examining the status of the design and operation of insider trading prevention rules, and considering whether further strengthening of insider trading prevention systems is necessary.

Case: Submission of Written Pledges for Insider Trading Prevention

The PICOQC requires all members to submit a written pledge to comply with the “Rules for Preventing Insider Trading,” which prohibit members from trading in specified securities of audited entities to which the audit firm provides services. However, such written pledges **were required only at the time of hiring**, and no insider trading prevention measures, such as monitoring members’ transactions in specified securities, were implemented thereafter.

(Article 26 of the Act; QCSS No. 1, paragraph 19 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

《Points to Note》

In addition to the cases described above, the following deficiencies have also been identified:

- **The audit firm has not comprehensively established internal rules, as it only prohibited transactions in specified securities of entities to which services are provided under the “Rules for Preventing Insider Trading” and prohibited excessive entertainment and gifts under the “Code of Conduct and Ethics”;**
- **Although the “Rules for Preventing Insider Trading” stipulate that a list of entities to which services are provided shall be distributed to members in order to raise awareness of insider trading, the individual responsible for insider trading prevention did not distribute such a list; and**
- **Although members were instructed to submit written pledges not to trade in specified securities of entities to which services are provided in accordance with the “Rules for Preventing Insider Trading,” written pledges from certain members were not obtained, as the submission status was not monitored.**

3. Professional Ethics and Independence

Points of Focus

For audits performed by CPAs to be viewed as trustworthy by stakeholders, it is essential that auditors maintain a fair and impartial attitude, not be influenced by any specific interests, and make fair judgments on the appropriateness of financial statements. Accordingly, audit firms are required to establish policies and procedures regarding professional ethics and independence in order to objectively demonstrate that auditors maintain such impartiality. In addition, engagement partners are required not only to comply with such policies and procedures themselves but also to ensure that audit personnel comply with them.

In consideration of the above, CPAAOB inspects audit firms with respect to professional ethics and independence from the following perspectives:

- ▶ Whether the audit firm obtains, at least annually, confirmations regarding compliance with policies and procedures for maintaining independence from all persons subject to independence requirements, and whether appropriate confirmation procedures are performed based on the categories of such persons;
- ▶ Whether the audit firm performs independence confirmation procedures prescribed in its internal rules when accepting and continuing audit engagements, and, at the time of issuing the auditor's report, appropriately confirms that no changes in independence have occurred;
- ▶ Whether the audit firm has established and operates a framework to ensure that lists of entities subject to independence requirements, which are necessary for assessing whether persons subject to the requirements comply with independence rules, are updated in a timely and accurate manner;
- ▶ Whether the audit firm establishes and communicates policies and specific procedures relating to compliance with professional ethics, including fee dependency, employment restrictions, confidentiality, and gifts and hospitality, and whether audit personnel comply with such policies and procedures prescribed in the audit firm's internal rules;
- ▶ Whether the audit firm establishes and appropriately operates policies and procedures regarding long-term involvement in order to comply with statutory rotation requirements; and
- ▶ Whether substantive measures are taken to ensure compliance with professional ethics in light of the objectives of the mattersmattersmattersmattersmattersmattersmattersmattersrequirements set out inmatters required the ethicalethicalethicalethicalethicalethicalCode of Ethicsethical.

Outline of Inspection Results

As illustrated in the case examples below, deficiencies were identified, including cases where independence confirmation procedures prescribed in internal rules were performed only as a formal review and conclusions that there were no independence issues were readily reached, as well as cases where such procedures were not comprehensively performed. In addition, deficiencies were identified where internal rules were not updated in response to amendments to laws and regulations relating to

independence.

Possible causes of these deficiencies include instances in which the PICOQC or equivalent did not clearly and specifically define procedures for independence confirmation (including procedures for updating lists of entities subject to independence requirements), the timing of such procedures, and the personnel responsible for implementation.

Expected Response

Given that deficiencies relating to professional ethics and independence continue to be observed, audit firms should, in order to enhance the reliability of audits, comply with the fundamental principles set out in the “Code of Ethics” issued by the JICPA and establish appropriate operations management frameworks by applying the conceptual framework approach. In addition, when identifying, evaluating, and addressing threats to independence, audit firms should conduct careful assessments based on actual circumstances. (Refer to [Figure 4])

[Figure 4] Conceptual Framework Approach



Source: Prepared by the CPAAOB

Case 1: Confirmation of Independence in Collegial Review

As part of the independence confirmation procedures for collegial review, the audit firm verbally confirmed the independence of prospective review committee members, and, where no independence issues were identified, recorded in the "Independence Confirmation" section of the "Review Request Form" that the independence confirmation procedures had been completed.

However, the audit firm **did not perform independence confirmation procedures for some prospective review committee members.**

(QCSS No. 1, paragraphs 20 and 38 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29, QCSS No. 2, paragraph 18))

Case 2: Confirmation of Independence When Accepting New Audit Engagements

The audit firm performs independence confirmation procedures for members who conduct preliminary investigations for new audit engagements prior to commencing such investigations, and for other engagement team members before the start of audit engagements.

However, **the audit firm did not establish internal rules that set out specific procedures for independence confirmation, such as the persons subject to the procedures and timing of implementation.** As a result, for some audit engagements, **independence confirmation**

procedures prior to preliminary investigation or prior to commencement of audit engagements were not performed.

(QCSS No. 1, paragraph 20 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

Case 3: Inadequate Preparation of a List of Entities Subject to Independence Requirements

In performing independence confirmation procedures, the audit firm prepared a list of entities subject to independence requirements and attached this list to the independence checklist for confirmation. However, the audit firm did not verify the completeness of the list and omitted **multiple entities subject to independence requirements.** In addition, in performing independence confirmation procedures, although there were omissions in the responses obtained from partners and personnel, the audit firm did not ascertain the reasons therefor and therefore did not sufficiently verify compliance with independence requirements.

(QCSS No. 1, paragraphs 20 and 21 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

Case 4: Assessment of Network Relationships



The audit firm entered into a membership agreement with a certain network for the purpose of “cooperating among members in providing services to existing clients and acquiring new clients, as well as forming and maintaining a network of international accounting firms with high quality and reputation.” Based on the right to use the brand name granted under the membership agreement, the audit firm publicly indicated that it is a member of the network, including by using the brand name on its website.

However, the audit firm resolved at a partners’ meeting that no network exists to which the audit firm belongs, on the grounds that there is no ownership or control relationship within the network. As a result, the audit firm did not assess the application of network-related provisions in the Code of Ethics in accordance with the intent of Ethics Rule R400.53, which requires that “a network must be determined to exist when entities are structured for the purpose of cooperation and share a common brand name.”

(Ethics Rule R400.53)

Case 5: Framework for Obtaining Information on Non-Audit Services Provided by Related Entities

The audit firm performed non-audit services, such as financial due diligence, based on engagements outsourced from related entities.

However, **the audit firm did not establish policies and procedures for maintaining independence in relation to the acceptance of non-audit engagements by related entities.** In addition, with respect to non-audit services performed by the audit firm, the audit firm did not establish specific procedures regarding: a) assessment of whether such services fall within prohibited non-audit services, including consideration of capital relationships between the client of

the non-audit services and the audited entity and the nature of such services; (b) consideration of safeguards to be applied when providing non-audit services; and (c) approval by the engagement partner and the PICOQC.

(QCSS No. 1, paragraph 1, 20 and 21 (prior to the 2022 revision) [Reference] QCSS No. 1, paragraph 29)

Case 6: Long-term Involvement of Engagement Personnel



With respect to the long-term involvement of key engagement personnel, including engagement partners and EQC reviewers, the audit firm stipulated in its internal rules on rotation that it must assess the significance of threats to independence and, where necessary, apply safeguards to eliminate such threats or reduce them to an acceptable level.

However, when appointing as an engagement partner an individual who had been involved for a long period as audit personnel, the audit firm did not assess whether threats to independence existed, taking into account the role performed and the duration of involvement by that individual.

(QCSS No. 1, paragraph 24 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29), Ethical Code R540.10)

Case 7: Calculation of Fee Dependency

Fees received from a specific audited entity accounted for more than 15% of the audit firm's total fees for 2 consecutive periods. As a safeguard, the audit firm requested an external CPA, who was not affiliated with the audit firm, to perform a review after issuance of the audit opinion. In calculating fee dependency, the firm included in the numerator both the audit fees from the audited entity and the total audit fees from its consolidated subsidiaries.

However, **the audit firm did not establish criteria for determining “cases in which fees account for a significant proportion” or “significantly exceed 15%,” as referred to in the Interpretive Guidance for Professional Ethics, and did not assess whether such criteria were met. In addition, the audit firm did not identify related entities in accordance with such guidance and did not assess whether there were related entities that should be considered in calculating fee dependency.**

(Guideline for Independence, Part 1, paragraphs 27, 220 and 222 (prior to abolition in 2023) [Reference] Ethical Code, R400.20, paragraphs 410.10 A1-A3, 410.14 A1, and 410.14 A3-A4, Interpretive Guidance for Professional Ethics Q1 and Q13 (prior to abolition in 2023) [Reference] Practical Guidance on the Code of Ethics, No. 1, Q410-5-1 to Q410-5-6, QG-4-1)

Case 8: Involvement Period of Engagement Partner

After ceasing involvement as an engagement partner due to rotation requirements, the CEO attended meetings to report audit results to representative directors of certain audited entities during the cooling-off period.

However, although the individual responsible for independence was aware of this fact, no assessment was performed from the perspective of independence, including whether the CEO's participation had a direct impact on the outcome of audit engagements.

(QCSS No. 1, paragraph 20 (prior to the 2022 revision) ([Reference] QCSS No. 1, paragraph 29))

Case 9: Employment with an Audit Client

A former partner who had been involved in audit engagements for an audited entity was scheduled to assume a position as an officer of that entity. In assessing threats to independence and their significance, the audit firm only confirmed whether audited financial statements had been issued during the period between the partner's resignation as engagement partner and the assumption of the position.

However, the audit firm did not assess other relevant factors, including whether economic benefits had been provided by the audit firm to the former partner, whether the audit firm had any outstanding obligations to the former partner, or the extent of the former partner's continuing involvement in the firm's professional services.

(Guideline for Independence, Part 1, paragraphs 135 and 139 (prior to abolition in 2023) ([Reference] Ethical Rule R524.4 and R524.6))

Case 10: Payment of commission for referral to assurance services

The audit firm paid its personnel a certain percentage of the contract value of assurance engagements as compensation for referrals that resulted in the conclusion of such engagements. In addition, the firm engaged external business partners to identify and introduce new clients and paid them referral fees for assurance engagements.

However, such payments violated the Code of Ethics, which prohibits the payment of referral fees in relation to assurance engagements.

(Code of Ethics, Article 23 (prior to the 2022 revision) [Reference] Ethics Rules paragraphs 330.5 A1, R330.5 (JP))

«Points to Note»

In addition to the cases described above, the following deficiencies have been identified.

- **The firm included, in the denominator used to calculate the fee dependency ratio, fees received by partners engaged in outside activities from companies at which those partners serve as part-time directors; however, the audit firm did not consider whether it is appropriate to include such fees as income of the audit firm in the denominator.**
- **The audit firm had neither established policies and procedures regarding the long-term involvement of audit personnel, nor had it established criteria for identifying persons subject to rotation or determining when safeguards are required to eliminate or reduce threats to independence.**

Safeguards Regarding Fee Dependency

If fees received from a client for a specific audit engagement account for a large proportion of the total income of the audit firm expressing an audit opinion (hereinafter referred to as "fee dependency"), concerns about losing fees from such client for audit and other non-audit services may influence the level of self-interest of the auditor. This creates a self-interest threat to independence by giving rise to undue pressure. Accordingly, it is necessary to consider and implement safeguards to eliminate the threat or reduce it to an acceptable level.

<Calculation of Fee Dependency >

The calculation of fee dependency is described in Q410-5-4 of Practical Guidance No. 1, "Q & A on the Code of Ethics (Practical Guidance)." For details, please refer to the guidance.

The total fees received from the client and its related entities;

Total income of the audit firm

< Safeguards for Audit Engagements for Public Interest Entities (PIE) >

When providing audit services to a client that is a Public Interest Entity (PIE) (*), the audit firm is required to apply the following safeguards regarding fee dependency (where such safeguards are determined to be appropriate):

- When fee dependency from the client represents, or is likely to represent, more than 15% for two consecutive years: A review equivalent to an engagement quality control review performed by a professional accountant who is not a member of the audit firm, prior to the issuance of the audit opinion for the second year.
- When such circumstances continue for five consecutive years: The audit firm shall, in principle, cease to act as auditor after the audit opinion for the fifth year has been issued.

It should also be noted that, under the revised Code of Ethics, the provisions on safeguards relating to fee dependency have been amended, and post-issuance reviews (including periodic inspections or reviews by JICPA) are no longer recognized as safeguards for audit engagements for PIE.

(*)Public Interest Entity (PIE) refers to "Large company etc." under the Act and other entities that are additionally treated as PIEs by the audit firm.

4. Acceptance and Continuance of Engagements

(1) Assessment of Risk Associated with Acceptance and Continuance of Engagements

Points of Focus

In order for audit firms to reasonably ensure audit quality, it is necessary to carefully assess engagement risks prior to the acceptance or continuance of audit engagements. This requires collecting a wide range of information, including information relating to the integrity of the audited entity. If an audit firm performs an insufficient risk assessment regarding the circumstances of the audited entity, or makes a judgment on whether to accept or continue an engagement based on an incorrect understanding of its audit engagement structure, it may result in a failure to adequately fulfill its responsibilities as an auditor. Accordingly, it is evident that careful judgment based on sufficient and appropriate information is required when accepting or continuing audit engagements.

For this purpose, audit firms are required to consider, for example, the following matters when accepting or continuing audit engagements:

- ▶ Whether engagement risks exist, including risks relating to the integrity of management (note that interviews with management are useful in assessing such integrity);
- ▶ Whether the audit firm is able to assign sufficient and appropriate personnel and time, and perform audit procedures in accordance with the identified engagement risks;
- ▶ Whether the audit firm has audit personnel with the knowledge, experience, and capabilities necessary to appropriately address the identified engagement risks; and
- ▶ Whether compliance with relevant requirements relating to professional ethics and independence can be ensured.

In particular, when assessing the integrity of management, audit firms should obtain information considered necessary based on the specific circumstances. Where issues are identified, audit firms should carefully consider whether to accept or continue the engagement and appropriately document the basis for their conclusion.

Furthermore, audit firms are required to establish policies and procedures for the acceptance and continuance of audit engagements that include assessing engagement risks, including fraud risks, and requiring that such assessments be reviewed by an appropriate function or individual outside the engagement team, at the time of acceptance and, for continuance, depending on the level of risk.

In consideration of the above, the CPAAOB inspects audit firms from the following perspectives:

- ▶ Whether specific procedures for assessing engagement risks have been established and whether such risks are appropriately assessed;
- ▶ Whether identified engagement risks are appropriately reflected in the audit plans for individual engagements;
- ▶ Whether, in forming the audit engagement team, sufficient consideration is given to whether the audit firm has the competence, capabilities, and resources necessary to perform the engagement;

and

- ▶ Whether engagement risks are evaluated and approvals within the audit firm are made in a timely and appropriate manner.

Outline of Inspection Results

Acceptance and continuance of audit engagements are core management decisions for audit firms. However, as illustrated in the case examples below, deficiencies were identified, including cases in which risk information —such as information relating to the integrity of management obtained by the prospective engagement partner through preliminary investigations, handovers from predecessor auditors, and prior-year audits—was not appropriately shared among those responsible for approving the acceptance or continuance of engagements (e.g., the partners' meetings), resulting in inadequate risk assessment. In addition, deficiencies were identified where audit firms did not appropriately sufficiently consider the audit resources required for the engagement, as well as appropriately assess risks cases in which, despite identified identified identified identified identified identified identified identifying identified inappropriate revenue transactions or significant deficiencies in internal control that should be disclosed, appropriate risk assessments were not performed.

Causes for the identified deficiencies include the following:

Prospective engagement partners prioritized expediting the conclusion of audit engagements and early commencement of work over conducting careful risk assessments and appropriately resolving identified issues;

Prospective engagement partners lacked sufficient experience to make appropriate judgments regarding management fraud, internal control audits, and accounting estimates, and therefore did not appropriately assess engagement risks based on facts identified through preliminary investigations and handovers;

When discussing whether to accept new audit engagements, partners did not sufficiently understand the importance of conducting firm-wide risk assessments based on information obtained from predecessor auditors, and partners other than the prospective engagement partner failed to critically evaluate engagements obtained by other partners.

(Observed Effective Efforts)

The following are examples of effective efforts observed at audit firms.

When considering acceptance of an engagement for a high-risk entity in which revenue fraud had been identified in the previous period, the audit firm carefully evaluated the status of internal controls designed to prevent fraud. The prospective engagement partner obtained not only information from management and internal personnel, but also objective and detailed information to corroborate management's assertions, including by interviewing external experts directly involved in the entity's fraud prevention measures;

To establish an environment in which companies preparing for listing can receive appropriate audits, the audit firm has established a dedicated department within its organizational structure. This department provides consultation services to such companies, supports engagement teams to ensure audit quality, and plans and implements training to develop personnel capable of conducting audits of IPO-ready entities.

Expected Response

In determining whether to accept or continue audit engagements, audit firms should identify engagement risks and consider appropriate responses based on information obtained through preliminary investigations, handovers from predecessor auditors, and prior-year audits, as well as the integrity of the audited entity, taking into account their own capabilities and resources. Audit firms should not allow their financial or operational priorities to unduly influence such decisions and should exercise due care to avoid inappropriate conclusions.

In recent years, there have been many cases of audited entities changing auditors from large audit firms to mid-tier or small and medium-sized audit firms. In particular, where the circumstances surrounding such changes indicate elevated engagement risk, audit firms should exercise enhanced caution.

In addition, the number of new engagements for audits equivalent to those required under Article 193-2, Paragraph 1 of the Financial Instruments and Exchange Act for entities preparing for listing has increased significantly. As many such entities face challenges in internal control and governance frameworks, audit firms should carefully assess whether they can perform audits of appropriate quality, paying particular attention to the following:

Carefully evaluate the integrity of management.

Assess whether it is possible to perform audits commensurate with engagement risks by securing sufficient and appropriate audit resources, including personnel and time; and

Ensure the availability of audit personnel with the necessary knowledge, experience, and capabilities, including expertise relevant to IPO-related engagements.

Furthermore, from the perspective of establishing a framework for continuously providing audit services to IPO-ready entities, audit firms need to develop personnel capable of handling such engagements and to accumulate and centralize relevant knowledge and expertise.

Case 1: Implementation of Risk Assessment Procedures when Accepting New Audit Engagements

- ① The prospective engagement partner had assessed engagement risk as high after identifying, from prior-year audits, that submission of audit reports had been delayed due to deficiencies in the audited entity's accounting and management systems. The prospective engagement partner made inquiries to the predecessor auditor and, based on the responses received, concluded that there were no issues regarding the integrity of management, and submitted the matter to the partners' meeting for approval of the acceptance of the audit engagement.

However, although the prospective engagement partner had not conducted any direct meetings

with management, the partners' meeting approved the acceptance of the audit engagement based solely on the results of inquiries made to the predecessor auditor, and did not sufficiently assess the integrity of management.

(QCSS No. 1, paragraphs 25 and 26 (prior to the 2022 revision) [Reference] QCSS No. 1, paragraph 30)



② In connection with the acceptance of a new audit engagement, the prospective engagement partner, through inquiries made to the predecessor auditor, became aware of circumstances such as inappropriate revenue recognition and material weaknesses in entity-level internal controls that should be disclosed.

However, the audit firm did not perform appropriate evaluations based on these circumstances with respect to items specified in its engagement acceptance checklist, including whether there was fraud or suspected fraud and whether there were significant deficiencies in internal control. (QCSS No. 1, paragraphs 25, 26, and F26-2 (prior to the 2022 revision) [Reference] QCSS No. 1, paragraphs 30 and F30 -2JP, ASS No. 220, paragraphs 11 and F11-2 (prior to the 2022 revision) [Reference] No. 220, paragraphs 22, F22 and 2JP)

《Points to Note》

In addition to the cases described above, the following deficiencies have also been identified:

- **Cases where audit engagements are approved before completing procedures required by the audit firm, such as obtaining responses to inquiries made to the predecessor auditor or obtaining approval at the partners' meeting;**
- **Cases where auditors accept appointments based on the assumption that, even if issues are identified as a result of necessary engagement risk assessment procedures after acceptance, such appointments can be readily withdrawn; and**
- **Cases where, in the context of mergers with other audit firms, sufficient consideration is not given to audit engagements undertaken by the merged firm.**

It should be noted that, even in the case of a merger of audit firms, necessary procedures, including engagement acceptance procedures, must be completed and appropriate engagement risk assessment procedures must be performed.

In addition, when obtaining information regarding the integrity of audited entities, audit firms should consider, with reference to paragraph A69 of QCSS No. 1 (as revised), the following examples:

- **For existing engagements, where applicable, information obtained from current or past engagements, or inquiries made to other personnel who have performed services for the client;**
- **For new clients, inquiries, in accordance with applicable ethical requirements, to persons currently or previously providing accounting or auditing services to the client;**
- **Discussions with third parties such as financial institutions, legal professionals, and other entities in the same industry; and**

- **Background checks using relevant databases, including, where appropriate, the use of external service providers.**

Case 2: Implementation of Risk Assessment Procedures upon Continuance of Audit Engagements

The engagement team identified significant matters in the audit of the audited entity, including material weaknesses in internal control that should be disclosed, disclosures relating to the going concern assumption, and transactions with a major shareholder whose business rationale was questionable. The engagement team also assessed such transactions as circumstances indicating a risk of material misstatement due to fraud.

However, upon the continuance of the audit engagement with the audited entity, **the audit firm did not sufficiently consider the procedures necessary to ensure audit quality, despite being aware that these matters presented significant challenges in maintaining audit quality.**

(QCSS No. 1, paragraphs 25, 26, and F26-2 (prior to the 2022 revision) ([Reference] QCSS No.1, paragraphs 30 and F30-2JP), ASS No. 220, paragraphs 11 and F11-2 (prior to the 2022 revision) ([Reference] ASS No. 220, paragraphs 22 and F22-2JP))

«Points to Note»

In addition to the cases described above, the following deficiencies have also been identified:

- **Cases where, in evaluating engagement risks upon the continuance of audit engagements, the engagement team identified that necessary audit information had not been provided by management in the previous audit, but did not assess the integrity of management from the perspective of possible scope limitations;**
- **Cases where, despite identifying material weaknesses in entity-level and process-level internal controls that should be disclosed, the engagement team did not assess the integrity of management in light of the entity's response to such deficiencies.**

Audit firms should note that, not only at the time of acceptance but also at the time of continuance of audit engagements, they are required to determine whether to continue the engagement only after identifying engagement risks and considering appropriate responses based on the information obtained.

Case 3: Securing Audit Resources

With respect to the continuance of audit engagements, the audit firm requires engagement partners to obtain approval from the EQC reviewer after evaluating the degree of engagement risk, taking into account factors such as the integrity of the audited entity, audit risks, and the availability of audit resources.

However, in considering whether to continue the audit engagement, the engagement team estimated the planned audit hours for the current period at the same level as those planned for the previous period, despite the fact that the actual audit hours for the previous period had significantly exceeded the planned hours. The engagement team did not consider specific methods

for reducing the audit hours while maintaining audit quality, nor did it consider the extent of reductions that could be achieved through such methods.

Furthermore, in approving the continuance of the audit engagement, the EQC reviewer did not assess the reasonableness of the planned audit hours estimated by the engagement team and did not sufficiently consider whether continued acceptance of the audit engagement was appropriate.

(QCSS No. 1, paragraph 25 (prior to the 2022 revision) [Reference] QCSS No. 1, Paragraph 30) QCSS No. 210, Paragraph 9, QCSS No. 220, Paragraphs 11 and A7 (prior to the 2022 revision) [Reference] QCSS No. 220, Paragraphs 22 and A50)

«Points to Note»

In recent years, there have been a number of cases in which listed companies have submitted amended securities reports due to the discovery of inappropriate accounting treatments. In such cases, as with ordinary financial statement audits, audit firms are required to ensure appropriate quality control throughout the entire process, from determining whether to accept the engagement to the issuance of the audit report. Where corrections of financial statements covering multiple periods are anticipated, auditors may require additional time to obtain sufficient and appropriate audit evidence compared with ordinary audit engagements. Accordingly, audit firms should carefully assess whether the planned number of audit days is sufficient.

(2) Communication with the Predecessor Auditor

Points of Focus

In cases where auditors change, information obtained by the predecessor auditor in prior audit engagements is highly important. Accordingly, both the predecessor auditor and the prospective auditor are required to ensure appropriate communication between audit firms so that the prospective auditor can obtain useful information for determining whether to accept the engagement and for performing the audit.

In consideration of the above, CPAAOB inspects audit firms in terms of their communication with predecessor auditors from the following perspectives:

- ▶ Whether the predecessor auditor communicates in a timely and sufficient manner to provide useful information to the prospective auditor for determining whether to accept the engagement and for performing the audit, and responds honestly and clearly to inquiries made by the prospective auditor; in particular, where information relating to material misstatements that have affected or may affect the audit opinion has been identified, whether such information is fully communicated;
- ▶ Whether the prospective auditor, in order to appropriately determine whether to accept an audit engagement, makes inquiries of the predecessor auditor regarding all matters required under auditing standards, including the reasons for the change of auditors and the status of responses to fraud risks;

- ▶ Whether the prospective auditor and the predecessor auditor mutually confirm the content of the communication performed and each prepares and retains appropriate documentation;
- ▶ Whether the audit firm ensures that communication with the predecessor auditor has been appropriately conducted by requiring the engagement team to report the results to an appropriate function or individual outside the engagement team; and
- ▶ Whether, where acceptance of an audit engagement has been declined or an existing engagement has been terminated due to identified or suspected non-compliance with laws and regulations, the predecessor auditor, upon request from the prospective auditor, provides all relevant facts and information necessary for the prospective auditor to determine whether to accept the engagement.

Outline of Inspection Results

Deficiencies were identified where inquiries to the predecessor auditor were not appropriately conducted, as well as cases where the predecessor auditor did not properly convey its assessment of management's integrity to the prospective auditor.

Causes of these deficiencies include cases where the prospective engagement partner prioritized expediting the acceptance and commencement of engagements over conducting careful risk assessments and appropriately resolving identified issues. In addition, deficiencies were observed where the PICOQC assumed that, once policies and procedures regarding termination of engagements and communication with predecessor auditors had been established, engagement teams would comply with and appropriately implement them.

Expected Response

The predecessor auditor should recognize the importance of providing clear and sufficient information to the prospective auditor regarding audit risks and other relevant matters identified during prior audit engagements.

In addition, the prospective auditor should establish a framework to ensure that information obtained through communication with the predecessor auditor is properly documented and effectively utilized in performing the audit.

Similarly, in cases where engagement teams change within the same audit firm, information relating to audit risks should be appropriately communicated. In particular, important audit matters, including fraud risks, should be clearly and sufficiently conveyed from the predecessor engagement team to the successor engagement team.

Case: Provision of Information to the Prospective Auditor

In connection with the handover of an audit engagement, the audit firm communicated to the prospective auditor its assessment that no significant issues were identified regarding management integrity.

However, the engagement partner of the audit firm had, in an application for withdrawal from the audit engagement prepared as part of the firm's internal procedures, explained that there were significant

concerns regarding management integrity. Despite this, **the engagement partner did not accurately communicate this assessment to the prospective auditor during the handover**. In addition, the audit firm's quality control function had not established procedures to identify discrepancies between the minutes of the audit engagement handover and the application for withdrawal from the audit engagement. (QCSS No. 1, paragraphs 27 and 60 (prior to the 2022 revision) [Reference] QCSS No.1, paragraphs 34 and 62 jp, QCSS No. 900, paragraph13)

《Points to Note》

In addition to the cases described above, the following deficiencies have also been identified:

- **Cases where the prospective engagement partner did not make inquiries to the predecessor auditor;**
- **Cases where, due to a rapid increase in new audit engagements resulting from business expansion, required procedures for the handover were not performed in accordance with the audit firm's established policies within the prescribed timeframe;**
- **Cases where, because the predecessor auditor was a large audit firm, the engagement team accepted the audit engagement without sufficiently evaluating the appropriateness of the audited entity's accounting policies, and it was subsequently identified that such policies had been inappropriately applied.**

In performing the handover, audit firms should note that excessive reliance should not be placed on the predecessor auditor and that a cautious approach is required.

5. Recruitment, Education and Training; Evaluation and Assignment

(1) Recruitment, Education and Training

Points of focus

During its inspections, the CPAAOB investigates, from the following perspectives, whether the audit firm has established and is following policies and procedures concerning the recruitment of audit team members:

- ▶ Whether the audit firm has specific policies and procedures concerning recruitment, and whether they are properly operated.

Furthermore, auditors, as professional experts, are expected to always strive to develop their expertise and accumulate knowledge that can be obtained through practical experience, etc. The CPAAOB inspects education and training provided at each audit firm from the following perspectives:

- ▶ Whether the audit firm develops and provides education/training programs that sufficiently take into account the knowledge, experience, competence and capabilities of the professional staff;
- ▶ Whether the audit firm provides education/training programs designed to maintain and improve the audit competence and capabilities of the professional staff; this may include, for example, accurately identifying areas where professional staff tend to have less understanding and providing training focusing on these areas; and
- ▶ Whether the engagement partner provides direction and supervision to professional staff so that they can fully utilize and exercise the knowledge and awareness acquired in the training in audit field work.

Outline of inspection results

As shown in the case examples below, when recruiting professional staff, emphasis was placed on the administration of the audit division rather than the administration of the audit firm as a whole, so recruitment was sometimes unsuited to the audit firm as a whole.

Furthermore, deficiencies in education and training for professional staff were observed, with some firms not providing effective training programs and others failing to provide opportunities for education and training in areas that require special knowledge.

Other deficiencies included a failure to have staff members who have not participated in mandatory training programs do so within the period prescribed by each audit firm despite having identified those persons.

The causes of these deficiencies included a lack of commitment to establishing an appropriate education and training system. For example, in some cases, the PICOQC, etc. depended entirely on engagement partners' direction and supervision in audit field work in encouraging staff members to acquire engagement-related knowledge. In other cases, the PICOQC was not aware of the need to check whether staff members have participated in mandatory training programs.

There were also cases in which audit firms lacked commitment to maintaining and improving audit quality by ensuring that audit team members have a certain level of engagement-related knowledge as a whole, as they left the improvement of skills to the discretion of individual audit practitioner, including part-time staff.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- ▶ The audit firm has set the required number of credits of training about fraud risk at 12 per year, higher than the necessary minimum of 6 credits per year prescribed by the JICPA, under its rules on training, as it believes that learning widely about examples of fraud at other audited companies helps to enhance “the ability to detect fraud” given the limited number of audit engagements performed for listed companies by the audit firm, etc.
- ▶ At training sessions to inform personnel of deficiencies identified in CPAAOB inspections and QC reviews, the audit firm informed personnel of specific areas highlighted and areas where improvements were required by presenting as much of the content of the audit documentation as possible.
- ▶ Staff who have not taken the mandatory training courses designated by the audit firm are obliged to take a test concerning the course content so that the firm is able to check the extent of their knowledge of audit engagements and the like.
- ▶ Not only is it obligatory for part-time personnel to attend training sessions held once a month at least five times a year, but part-time personnel are also appointed as trainers to encourage them to actively participate in training.
- ▶ The audit firm recognizes that part-time professional staff account for a high proportion of professional staff, and is strengthening its recruitment of full-time professional staff and converting part-time professional staff to full-time professional staff as improvement measures. In addition, the firm is giving careful consideration to renewing contracts with part-time professional staff who engaged in for fewer days.



Expected response

Audit firms, when recruiting assistants to engagement partner, should appropriately estimate the necessary number of personnel in light of factors such as the current audit workload, the number of new audit contracts expected to be concluded, and the number of staff members expected to leave the firm in the future.

Furthermore, when providing education and training for audit teams, firms must maintain and improve the skills of engagement team members (including part-time and non-qualified engagement team members) by accurately identifying the areas of audit where they lack sufficient understanding and by preparing and implementing training programs that give due consideration to their respective knowledge, skills and experiences. Moreover, it is necessary to implement effective measures to ensure

staff members' participation in mandatory training programs, such as conducting follow-up checks as to whether they have appropriately participated in the mandatory training programs designated by each audit firm. It is also important to enhance the effectiveness of education and training through reviews of audit documentation, etc. so that knowledge and perspectives acquired through training programs can be fully put to use in audit field work.

Case 1: Recruitment of staff

Due to the circumstances surrounding its establishment, the audit firm is divided into two divisions, and in one of the divisions **insufficient time is made available for audit documentation review, engagement quality control review, and quality-control-related tasks, as engagement partners are busy with performing audit procedures for the accounts they are in charge of.** Despite this situation, the CEO makes decisions regarding the hiring of professional staff based on the P/L of each division and is failing to optimize recruitment for the firm as a whole.

(QCSS No. 1, paragraphs 17, 28, and A20 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs 28, 32, and A90))

Case 2: Effectiveness of training

- ① The audit firm's quality control rules stipulate that opportunities for necessary training and appropriate opportunities for fraud-related education and exercises should be provided to all audit team members. Its anti-insider trading rules obligate all partners and other staff members to participate in the training program concerning anti-insider trading efforts designated by the audit firm.

However, **although an accounting fraud case has occurred at an audited company, the audit firm has not provided opportunities for fraud-related training and exercises by implementing fraud-related training on its own, and so on.** Moreover, the audit firm has not designated a training program concerning anti-insider trading efforts in which partners and other staff members should participate as prescribed by its anti-insider trading rules.

(QCSS No. 1, paragraphs 28 and F28-2 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs 32, F32-2JP))

- ② The audit firm obliged all partners and professional staff members to earn at least 40 credits per year from continuing professional education (CPE) programs offered by the JICPA (currently known as Continuing Professional Development (CPD)) and also held two periodic training sessions per year of its own, along with other ad hoc training courses as needed.

However, although the PICOQC was aware that partners and professional staff members lacked an understanding of audit standards and of the level of procedures required under current audit standards, **they failed to prepare and implement training programs that took into account the causes, based on a sufficient analysis of deficiencies identified in QC reviews.**

(QCSS No. 1, paragraphs 28 and A22(before amendment in 2022) [Reference] QCSS No. 1, paragraphs 32 and A88)))

Case 3: Education and training of part-time professional staff

The PICOQC and the person in charge of training believed that because most of the part-time staff had experience of audits at large-sized audit firms, there were no problems with their ability, and therefore did not provide training on audit standards.

(QCSS No. 1, paragraphs 28, A21, and A22 (before amendment in 2022) ([Reference] QCSS No. 1, paragraphs 32 and A88))

«Points to Note»

In addition to the above cases, the following deficiencies have been identified:

- **Audit firms left the maintenance and improvement of knowledge, competence/capabilities to individual effort of each professional staff. They only monitored the achievement status of practitioners' CPD)enrollment obligations, and did not develop an education and training fully considered on audit experience, the audit engagements, and audit standards that were newly introduced;**
- **Audit firms did not continuously conduct education and training to improve the audit quality control capabilities for engagement partners. It resulted in many deficiencies identified in certain individual audit engagements; and**
- **The cause of the deficiencies in individual audit engagements was insufficient education and training for professional staff.**

In many cases, where deficiencies were identified in individual audit engagements, there was insufficient understanding of audit standards resulting from deficiencies in the education/training for professional staff. There are also many cases where the cause of deficiencies in individual audit engagements lay in the education and training of audit teams.

(2) Evaluation, Compensation, and Promotion

Points of focus

Audit firms are expected to design appropriate policies and procedures for compensation, performance evaluation, and promotion of personnel that places a high priority on audit quality. The CPAAOB inspects the conditions of establishment and implementation of procedures for the evaluation, compensation, and promotion of professional staff, from the following perspectives:

- ▶ How the audit firm reflects the attitude of placing high priority on audit quality in the policies and procedures relating to personnel affairs;
- ▶ Whether the audit firm has designed and properly followed its policies and procedures for

performance evaluation, compensation and promotion of personnel with which the competence and capabilities (especially quality control capabilities) of professional staff and their compliance with professional ethics are fairly evaluated and appropriately rewarded.

Outline of inspection results

Some audit firms did not evaluate audit team members based on professional skills (quality control-related skills in particular) and compliance with professional ethics.

The reasons given for this deficiency include: evaluation of professional staff and determination of their remuneration were based on the CEO's subjective assessment; there were no major differences in the quality of audit engagements performed by professional staff; and it was important to ensure that there were no differences in evaluation among professional staff because the audit firm is a small organization.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

As a way of placing emphasis on audit quality, the audit firm adopted as many as 12 evaluation items related to quality control, including the level of understanding of audit procedures and accounting standards, among all 17 evaluation items of partners set by the firm.

Expected response

Audit firms need to **establish and implement policies and procedures in order to evaluate professional competence and capabilities, particularly those of quality control, and compliance with professional ethics of members**, taking into consideration the size, personnel structure and other relevant factors of the audit firm.

In addition, audit firms should properly evaluate professional staff's efforts to improve and maintain their competence and capabilities as well as their compliance with professional ethics, and appropriately reflect the results of the evaluation in compensation, promotion, and composition of engagement teams, in order to fully reward such efforts.

Case 1: Policies and procedures for the evaluation of assistants to the engagement partner



When evaluating assistants to the engagement partner and calculating their remuneration, the audit firm stipulated that decisions should be made with due consideration to the execution of audit engagements, improvement of capabilities, and capability development through practical experience.

However, the partners' meeting only received reports on the evaluation results (evaluation points) for each engagement partner collected by the CEO and PICOQC, and the partners' meeting did not perform the audit firm's evaluation procedures, such as discussion and approval of the evaluation results. Furthermore, the audit firm only performed evaluations of engagement partner as a formality and **did not provide them with specific explanations of the evaluation results of each**

engagement partner and the basis for their evaluation. As such, the audit firm **did not establish a framework for fairly evaluating and rewarding engagement partner for enhancing and maintaining their capabilities.**

(QCSS No. 1, Nos. 15, 28, A20, and A24 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs 32, A90, A91, A92, and A93))

Case 2: Evaluation and compensation of partners

- ① At this audit firm, the CEO carried out evaluations of partners. Based on the performance of each partner, the CEO carried out individual evaluations of each partner on evaluation items such as "audit engagement," "audit quality," and "corporate management," and then carried out an overall evaluation on a three grade scale based on the results of the individual evaluations. In addition, as part of its policy for evaluating compensation based on overall evaluations, the CEO prepared a draft proposal for the following year's partner compensation based on each overall evaluation, and decided on the draft proposal for partner compensation after discussion at the partners' meeting. However, the process for evaluating partners and determining partner compensation at this audit firm was devised independently by the CEO, and the audit firm did not establish rules relating to this process or disseminate them to partners. In addition, the CEO **did not establish specific evaluation standards for each item in the individual evaluations, and all partners had the same evaluation results for the "audit quality" evaluation item.** Furthermore, the CEO did not clarify how the individual evaluations would be reflected in the overall evaluation, and thus evaluations of partners were not carried out in an effective manner. (QCSS No. 1, paragraphs 15, 16, 17, 28, A5, A20, and A24(prior to the revision in 2022) [Reference] QCSS No. 1, paragraphs 28, 32, A90, A91, A92, and A93))



- ② The audit firm stipulated that evaluations and compensation for partners were determined based on factors such as the term of office of the partner, the quality control of audit engagements performed, and the performance of the partner.

However, the audit firm did not establish specific evaluation standards for each evaluation item, nor did it clarify how each evaluation item would be reflected in partners' remuneration. As a result, the audit firm did not establish a system to reflect the evaluation of audit quality, etc. in determining partners' remuneration.

(QCSS No.1, paragraphs. 15, 17, 28, A5, A20, and A24 (before amendment in 2022) [Reference] QCSS No. 1, Nos. 28, 32, A90, A91, A92, and A93))

Case 3: Evaluation of Part-time Employees



When evaluating full-time personnel, the audit firm first performed a primary evaluation and then a secondary evaluation, with (I) work objectives, (ii) target figures, (iii) objectives other than direct work, (iv) management ability, (v) technical knowledge, (vi) work performance ability, and (vii) job

performance attitude rating as evaluation items, and then determined the evaluation and compensation on a five grade scale through discussions among partners.

However, **policies and procedures for evaluation of part-time personnel have not been established, annual evaluations have not been conducted, and a mechanism for determining the remuneration of part-time personnel by taking into account the quality and capability of audit engagements of each part-time personnel has not been established.**

(QCSS No. 1, paragraphs 15, 17, 28, A5, A20, and A24 (before the amendment in 2022) [Reference] QCSS No. 1 paragraphs 28, 32, A91, A92, and A93))

《Points to Note》

In addition to the above cases, the following deficiencies were identified in the evaluation of engagement partners.

- **Despite identification of persons with concerns about their quality control capability, etc. the firm's monitoring of audit engagements handled by such persons was inadequate.**
- **There are no clear standards regarding the relationship between the evaluation results of factors to be considered in employee evaluation and the classification of base salary evaluation, or regarding the conditions for the payment of evaluation salary.**

In addition, the following deficiencies were identified in the evaluation of part-time personnel engaged in audits.

- **Although personnel evaluations were conducted in the same way as for full-time personnel, the results of personnel evaluations were not sufficiently reflected in promotions / demotions or the composition of engagement teams out of concern that harsh treatment of part-time personnel would lead to their resignation and impede audit engagements.**

Evaluation, compensation, promotion, etc., are vivid illustrations of the CEO's management policies, and they also have a major impact on an audit firm's climate. The importance of this must be given due consideration when seeking to formulate appropriate policies and procedures and implement them.

(3) Assignment

Points of focus

When assigning professional staff to audit engagements, audit firms must select audit practitioners who have the knowledge, competence/capabilities and experience necessary to properly perform the audits, considering the business and characteristics of the audited companies, and who can take sufficient time for the assigned engagements.

In consideration of the above, in the inspections, the CPAAOB reviews the assignment of professional staff to engagements, including their appropriateness, from the following perspectives:

- ▶ Whether the audit firm has assignment policies and procedures to ensure that professional staff (including engagement partners) with the required competence and capabilities are assigned to

individual audit engagements;

- ▶ Whether, when assigning audit practitioners (including engagement partners), sufficient examinations are made for each audit practitioners regarding the time that can be spent on assigned audit engagements, understanding professional standards and laws, practical experience, abilities, etc.; and
- ▶ Whether, if a merger etc. has occurred, audit teams members (including engagement partners) are being appropriately assigned, regardless of their affiliation prior to the merger, from the standpoint of forming appropriate engagement teams for the audit firm as a whole.

Outline of inspection results

Deficiencies were observed in assignments, including cases where the assignment of an engagement partner and the composition of an engagement team were not appropriately conducted based on audit risks. Causes for the identified deficiencies were as follows:

The audit firm failed to appropriately conduct risk assessment based on the actual status of audited companies, or compose an engagement team based on risk assessment;

Audit firms appoint engagement partners mainly based on which audit department the partners belong to, without due consideration for their quality control skills;

The audit firm gave priority to acquiring new audit engagements without due consideration to the audit practitioners competence/capabilities and experience, or the performance capability of the audit firm as a whole; and

The audit firm did not correctly understand the QC competence of engagement partners and how much time they could spend on audit engagements.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- ▶ Following a merger, the audit firm has appointed partners in charge of individual audit engagements in a way that ensures that, after the expiry of each rotation period, each engagement partner and the partner in charge of the EQC review is replaced by a person who was affiliated with a different pre-merger audit firm so that the firm is able to promote integrated operation.
- ▶ The audit firm ascertained the operational workload of each partner by means of a comparative analysis of actual engagement performance against the annual engagement plan drawn up by each partner, and revised assignment of responsibility if necessary.

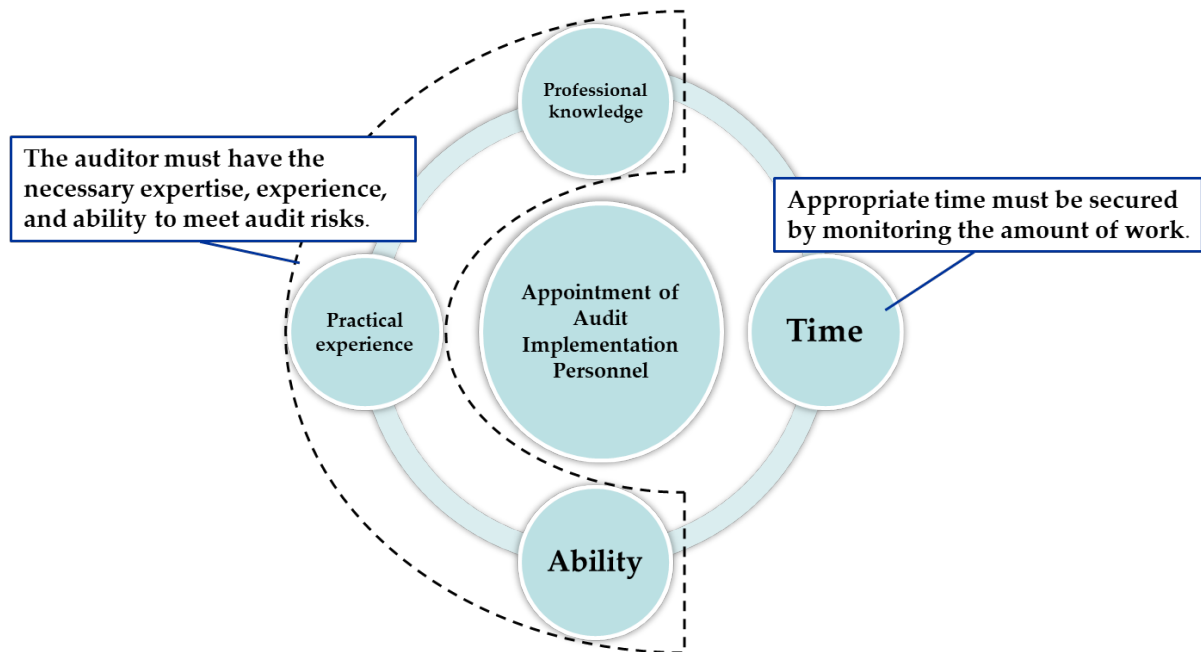
Expected response

Audit firms need to assign audit practitioners who have the professional knowledge, practical experience, and abilities, etc., required in accordance with the size, risk and business of audited companies. When forming engagement teams, audit firms need to give due consideration to the quality

control capabilities of engagement partner, and strive to establish a framework for the performance of audit engagements by quality control division, etc. that ensures that engagement partner, including engagement partner, have sufficient time to perform audit engagements by, for example, taking measures such as monitoring workload. (See Figure 5)

Note that if a merger etc. has occurred, an integrated response is required for the audit firm as a whole.

Figure 5: Considerations for Selection of Audit Practitioners



Source: Prepared by the CPAAOB

Case 1: Assignment of engagement partner

① When appointing engagement partners, **the audit firm did not identify the engagement partners' workload and level of involvement in each audit engagement , resulting in failure to conduct appropriate monitoring as to whether sufficient time was secured for engagement partners to perform their duties.**

(QCSS No. 1, paragraphs 29 and A26(before amendment in 2022) ([Reference] QCSS No. 1, paragraph 32))

② When accepting or continuing audit engagements, the audit firm identified audit engagements assessed as having high audit risk as high-risk audit engagements, and in consideration of the results of the risk assessment, determined the most suitable engagement partner and partner in charge of engagement quality control, and subject them to audit quality monitoring by the quality control division.

However, the audit firm **did not reconsider the assignment of engagement partners of some of the audit engagements selected as high-risk audit engagements from the perspective of**

identified audit risks, and did not select them as engagements subject to audit quality monitoring by the quality control division.

(QCSS No. 1, paragraphs 15 and 16(before amendment in 2022) [Reference] QCSS No. 1, Paragraphs 32 and 37))

Case 2: Composition of engagement team

Although the PICOQC was aware of issues in the composition of engagement teams in certain audit engagements of a regional office, he/she left audit responses including composition of engagement teams to regional office entirely and did not provide any instruction for improvement as headquarter audit division. **This led to insufficient monitoring by the audit division in head office for the composition of engagement teams at the regional office.**

(QCSS No. 1, paragraphs 15, 29, and 30(before amendment in 2022) ([Reference] QCSS No. 1, paraguraph 32))

Case 3: Assignment of IT auditors

With regard to the assignment of IT auditors for each engagement team, the individual responsible for IT had a policy of checking whether or not they were certified as "IT audit experts" as stipulated by the audit firm, and whether they had appropriate capabilities in light of the degree of complexity of IT in the audited company they are in charge of.

However, the procedures for assigning IT auditors at this audit firm were found to have the following deficiencies:

- The individual responsible for IT stated that when assigning IT auditors, the individual evaluated their expert knowledge and capabilities based on audit documentation prepared by the IT audit experts in past years and the engagement team's evaluation, but he **did not record the standards applied in this evaluation, as well as the evaluation process and results.**
- The IT audit division manager only monitored the effort of IT audits estimated by the engagement team with regard to the degree of complexity of IT at the engagement, and **did not perform an adequate evaluation based on the use of IT and the IT environment at the audited company.**

(QCSS No. 1, paragraphs 30, and A27) (before amendment in 2022) [Reference] QCSS No. 1, paragraphs 32 and A98))

Case 4: Designation of a contact for conslutation



The audit firm's quality control rules stipulate the scope of specific cases on which inquiries for expert opinions should be made and the persons to whom inquiries for expert opinions should be made. In particular, the audit firm designated some of its representative partners (two persons) as persons to whom inquiries should be made regarding "matters relating to the audit of accounting estimates" and "analysis of complex or unusual challenges for compliance with tax laws."

However, the engagement team did not consider whether it would be appropriate, from the perspective of ensuring objectivity, to designate the representative partner as the contact for inquiries mentioned above, given that both of the two representative partners were engagement partner for audit engagements.

(QCSS No. 1, Paragraph 33 (prior to revision in 2022) ([Reference] QCSS No. 1, Paragraph 31), ASS No. 220, Paragraph 17 (prior to revision in 2022) ([Reference] QCSS No. 220, Paragraph 35))

6. Audit Documentation

(1) Preparation of Audit Documentation and Supervision/Review by Superior

Points of focus

Audit documentation provides evidence to show that an auditor has obtained the basis for issuing an auditor's report and that the auditor has conducted the audit in accordance with the generally accepted auditing standards. Thus, the audit documentation serves as evidence to directly and specifically demonstrate the audit procedures performed by the auditor.

On the other hand, especially in the case of audit procedures concerning significant or material matters, if the procedures performed were not recorded in the audit documentation, evidence other than the audit documentation (for example, oral explanations by an engagement team member who performed the procedures) cannot serve as solid and reliable evidence of the work performed by the auditor, or its conclusion. Auditors, as professionals, must pay full attention to this matter.

In consideration of the above, the CPAAOB inspects the status of the preparation of audit documentation and supervision/review by superiors from the following perspectives:

- ▶ Whether the audit firm has prescribed the information and techniques required for audits and informed audit teams of them;
- ▶ Whether engagement partners, during the process of conducting an audit, properly supervise the audit engagement by monitoring the progress of the audit engagement, finding out about important matters, etc. through the review of audit documentation and discussions with engagement teams;
- ▶ Whether professional staff prepare audit documentation in such a way to sufficiently and appropriately describe the types of audit procedures performed in accordance with generally accepted auditing standards, the nature, the timing and scope of audit procedures, the grounds for judgments, the conclusions reached, and other information;
- ▶ Whether more experienced members of the audit team appropriately review the audit documentation prepared by less experienced members; and
- ▶ Whether the engagement partner reviews the audit documentation and has discussions with the engagement team to confirm that sufficient and appropriate audit evidence has been obtained to support the reached conclusions and audit opinion.

Outline of inspection results

Concerning the preparation of audit documentation and supervision/review by superiors, many deficiencies, such as not documenting audit procedures performed by engagement teams and the basis for auditor's conclusion, were identified. Such deficiencies indicate that engagement teams did not perform appropriate audit procedures. . Furthermore, as a result of the failure of the engagement partner to review from the perspective of whether the audit procedures performed were appropriate and such procedures were sufficiently and appropriately documented, deficiencies in audit documentation

were identified.

Causes for the identified deficiencies were as follows:

- As the CEO and the PICOQC place excessive trust in engagement partners, they assume that if the quality control policy and procedures are prescribed by the quality control rules, the partners will appropriately review audit documentation and provide instructions to and supervise their assistants and other staff;
- The professional staff did not fully understand the important role of the audit documentation at the time when the audit firm conducts quality control related tasks or explains their audits to external parties;
- Engagement partners did not consider the need to supervise assistants or review audit documentation and left the audit procedures to audit assistants because they misunderstood that there was a shared awareness among the engagement team about audited company's issues and audit procedures to be performed, since the partner always accompanied on site audits and understood the situation; and
- The engagement partner did not sufficiently understand audit procedures through review of audit documentation and concluded his/her understanding by simply hearing oral explanation or equivalent from the assistants.

(Observed effective efforts)

The following case constitutes an effective effort observed at an audit firm.

- ▶ The audit firm has divided up audit engagement processes granularly into detailed work tasks and documented the content, timing, workload, persons in charge, etc., of each work task, making it possible to carefully manage the progress of audit engagements by engagement partners, and it is conducting suitable and timely reviews of audit documentation as well as providing supervision and instructions to assistants to engagement partners.
- ▶ By providing guidance about how to document the performed audit procedures and obtained audit evidence, the audit firm ensured that audit teams were informed of the level of audit procedures to be performed for individual audit engagements, as well as the required status of audit documentation, including the conclusions reached by practitioners and the basis for reaching their conclusions.

Expected response

audit firms should ensure that the professional staff is fully aware of the following items:


All procedures should be recorded clearly in the audit documentation, while confirming their adequacy and completeness; and

Professional staff must check that the audit procedures are consistent with the audit plan that was established, and describe the audit procedures performed, the results of the audit procedures and the audit evidence obtained in the audit documentation. the audit documentation must also include the

conclusions reached by audit practitioners as well as the basis of professional judgments for reaching such conclusions.

Engagement partners should exercise direction and supervision from the perspective of whether assistants could understand partner's instructions and whether assistants are performing tasks in accordance with the audit plan, etc. Engagement partners should also fully confirm, through the review of audit documentation, whether the conclusions reached by the engagement team are supported by the audit evidence obtained.

Case 1: Review of audit documentation

-  ① Because engagement partner did not have sufficient time to perform the audit engagements for which they were responsible, they did not provide appropriate instructions and **supervision to assistants to the engagement partner in terms of whether they appropriately identified and assessed the risks of material misstatement based on an understanding of the corporate environment and whether they obtained sufficient appropriate audit evidence for the identified risks of material misstatement, and they did not conduct in-depth reviews of audit documentation.**

(ASS No.220, paragraphs14, 15, and 16 (before amendment in 2022) ([Reference] ASS No.220, paragraphs29, 30, 31, and 32))

- ② Engagement partners lacked their understanding of procedures required by current audit standards and did not have adequate stance to reflect an understanding of the business of the audited company in audit plans and to verify the sufficiency of audit evidence and audit documentation. Furthermore, engagement partners **were not sufficiently critical because their assistants to engagement partners had audit experience at large-sized audit firms and had been engaged in current audit engagements for a long time, and they were not aware of the need to mutually check the audit documentation prepared by other partners.** Therefore, engagement partners did not sufficiently confirm whether appropriate audit procedures corresponding to risks had been performed and did not sufficiently confirm whether sufficient appropriate audit evidence had been obtained by reviewing audit documentation, etc.

(QCSS No. 1, paragraphs 31, A30, and A31 (before amendment in 2022) [Reference] QCSS No. 1, paras.31, A75, and A76), QCSS No. 220, paragraphs. 15 and 16 (before amendment in 2022) [Reference] QCSS No. 220, paragraphs 31 and 32))

Case 2: Instructions to and supervision of assistants to engagement partner

Engagement partners did not sufficiently identify and assess fraud risks in accordance with the audited company's business and its business environment and did not sufficiently plan procedures to respond to audit risks, and did not appropriately instruct or supervise audit procedures performed by assistants to engagement partners. Engagement partners also **did not conduct in-depth reviews**

of audit documentation from the perspective of whether management's assertions about accounting estimates were critically examined and whether sufficient appropriate audit evidence commensurate with the identified risks of material misstatement had been obtained.

(QCSS No. 1, paragraphs 31 (prior to revision in 2022) [Reference] QCSS No. 1, paragraph 31), QCSS No.220, paragraphs 14, F14-2, 15, F15-2, and 16 (prior to revision in 2022) [Reference] QCSS No.220, paragraphs 29, 30, 31, 32, and F34-2JP))

«Points to Note»

In addition to the above cases, the following deficiencies have been identified.

- **Engagement partners focused on examining the appropriateness of the accounting treatment of the audited company and neglected to examine whether the audit procedures performed met the level required by audit standards in review;**
- **Appropriate reviews were not performed in light of information obtained from the audited company;**

In the review, it is important to critically review whether the level of audit procedures performed by assistants to the engagement partner is consistent with current audit standards.

(2) Assembly of final audit files and control and retention of audit documentation

Points of focus

After the date of the auditor's report, and within the due period, auditors should assemble the audit documentation within the audit file, and complete the administrative procedures for the final assembly of the audit file. The audit firm should pay sufficient attention to the status of final assembly of the audit file and the control and retention of the audit documentation.

In consideration of the above, the CPAAOB inspects audit firms for final assembly of the audit file and control and retention of the audit documentation from the following perspectives:

- ▶ Whether the audit firm has established appropriate policies and procedures for the final assembly of the audit file;
- ▶ Whether the audit firm completed the final assembly of the audit file by the due date, by appropriately applying the policies and procedures mentioned above;
- ▶ Whether the audit firm ensures the traceability of any correction made after the final registration of the audit documentation and the reason and process for the correction, from the perspective of reliability of audit documentation;
- ▶ Whether the audit firm has policies and procedures properly in place for audit documentation so that confidentiality, safe custody, integrity, accessibility, and retrievability are ensured; and
- ▶ Whether the audit firm secures the confidentiality, safe custody, integrity, accessibility, and retrievability of audit documentation by appropriately applying the policies and procedures mentioned above.

Outline of inspection results

As shown in the cases below, there were cases in which audit documentation was newly prepared or revised based on the results of audit procedures performed after the date of the auditor's report, cases in which audit documentation was systematically falsified to avoid detection of deficiencies in external inspections, cases in which part of the audit documentation was not stored in the audit file, and cases in which, even though part of the audit documentation was revised after the deadline for completion of audit documentation, the specific reasons for the need for revision were not documented.

Furthermore, under the circumstances audit firms have introduced electronic audit documentation systems increasingly in recent years, because these systems are not being properly operated, the dates of preparation and review recorded electronic audit documentation are sometimes manipulated.

The main causes of the identified deficiencies included sense of guilt about preparing or amending audit documentation after the date of the audit report and a lack of awareness of the need to manage audit documentation.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- From the viewpoint of ensuring the confidentiality, safe custody, information integrity, accessibility, and retrievability of audit documentation, the audit firm converted audit documentation into an electronic format using audit software available in the market in light of its own resources.
- The time required to complete assembly of final audit file is shorter than that required by audit standards, etc.

Expected response

Audit firms should set appropriate quality targets for the preservation and retention of audit documentation, taking into account factors such as the safe storage, integrity, accessibility or recoverability of underlying data, controls over related technologies, and the use of IT applications. Each audit firm should reaffirm the importance of the control and retention of audit documentation, and re-examine the final assembly of the audit file and the control and retention of audit documentation, under the initiative of the PICOQC, etc. It should ensure that the final assembly of the audit file is completed within an appropriate period after the date of the audit report, and take all possible measures to prevent inappropriate additions to or modifications of audit documentation.

It should be noted that the final assembly of the audit file is nothing more than an administrative task, and performing new or additional audit procedures or drawing new conclusions is a violation of audit standards.

In addition, in moving forward with the digitalization of audit documentation, it is necessary to pay attention to whether the electronic audit documentation system is appropriately established and operated in accordance with the quality control rules established by the audit firm.

Case 1: Assembly of final audit file

- ① The audit firm established policies and procedures for the final assembly of the audit file and a deadline for completing the final assembly of the audit file in its quality control rules. In addition, if it became necessary to amend existing audit documentation or add new audit documentation after the deadline for completing the audit file documentation, the audit firm required to document (a) the specific reason for the amendment or addition, (b) the person who made the amendment or addition and the date of making the amendment or addition, and (c) the person who reviewed the amendment or addition and the date of reviewing, and developed a standard audit documentation format for this purpose.

However, the engagement partner **did not retain part of the audit documentation in the audit file, and even though some of the audit documentation had been amended after the deadline for completion of the documentation, the specific reasons for the need for amendments, etc. were not documented as prescribed.**

ASS No. 220, paragraphs 14, 15, and 16 (before amendment in 2022) ([Reference] ASS No.220, paragraphs. 29, 30, 31, and 32))

- ② Engagement partners did not sufficiently reflect an understanding of procedures required by current audit standards and an understanding of the business of the audited company in audit plans, and did not sufficiently verify the sufficiency of audit evidence and audit documentation.



Furthermore, engagement partners were not sufficiently critical because their assistants to the engagement partner had audit experience at large-sized audit firms and had been engaged in audit engagements for a long time, and they were not aware of the need to mutually check the audit documentation prepared by other partners. Therefore, engagement partner did not perform appropriate audit procedures corresponding to risks and did not sufficiently confirm whether sufficient appropriate audit evidence had been obtained by reviewing audit documentation, etc.

(QCSS No. 1, paragraphs. 31, A30, and A31 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs. 31, A75, and A76), QCSS No. 220, paragraphs. 15 and 16 (before amendment in 2022) [Reference] QCSS No. 220, paragraphs. 31 and 32))

Case 2: The date of preparation and review of the electronic audit documentation;

The audit firm's quality control rules stipulate that the person who prepared the electronic audit documentation and the date of preparation, as well as the person who reviewed the electronic audit documentation and the date of review shall be clearly identified through prescribed electronic signature procedures. However, the PICOQC did not prohibit post-hoc correction of the actual date of preparation and date of review of the audit documentation to a date prior to the date of audit report on the electronic audit documentation system, and did not instruct retention of the edit history of the audit documentation on the electronic audit documentation system.

As a result, although audit documentation was prepared and reviewed after the date of audit report

in some audit engagements, a deficiency was identified in that the date of preparation and date of review of audit documentation recorded on the electronic audit documentation system was corrected to a date prior to the date of audit report, and **no measures were taken to prevent post-hoc correction of the actual date of preparation and date of review of audit documentation.**

(QCSS No. 1, paragraph 31 (prior to revision in 2022) [Reference] QCSS No. 1, paragraphs 31), QCSS No.220, paragraphs 14, F14-2, 15, F15-2, and 16 (prior to revision in 2022) [Reference] QCSS No.220, paragraphs 29, 30, 31, 32, and F34-2JP))

《Points to Note》

In addition to the above, cases, the following deficiencies have been identified.

- **The person in charge of review focused on examining the appropriateness of the accounting treatment of the audited company and neglected to examine whether the audit procedures performed met the level required by audit standards;**
- **Appropriate reviews were not performed in light of information obtained from the audited company;**

In the process of promoting digitalization of audit documentation, it is necessary to pay attention to whether the electronic audit documentation system is appropriately established and operated in accordance with the quality control rules established by the audit firm.

7. Engagement Quality Control Review

Points of focus

In principle, audit firms should establish policies and procedures for reviews in order to objectively evaluate the audit procedures performed, the significant audit judgments and opinions made by the engagement teams throughout all audit engagements.

The CPAAOB inspects the appropriateness of review performed by the EQC reviewer from the following perspectives:

- ▶ Whether a person with the necessary experience and ability to perform the duties is appointed as the EQC reviewer, and whether they maintain objectivity and independence;
- ▶ Whether the EQC reviewer reviews the audit planning, significant audit judgments, and expressions of audit opinion in a timely manner;
- ▶ Regarding significant judgments and audit opinions made by the engagement team, whether the EQC reviewer discusses with the engagement partner, reviews audit documentation, evaluates audit opinions, and examines the appropriateness of financial statements and the draft of audit report, etc.;
- ▶ Whether the EQC reviewer examines the appropriateness of the evaluation of the engagement team members' independence, the necessity of consultation with experts and the conclusion reached, and whether the important judgments made by the engagement team were supported by sufficient and appropriate audit evidence, by reviewing the audit documentation; and
- ▶ Whether it has been appropriately documented that the procedures required by the audit firm's EQCR policies have been implemented, that the EQCR was completed before date of the auditor's report, and that there were no items deemed improper among the significant audit judgements and conclusions made by the engagement team.

Outline of inspection results

There were cases of deficiencies in the qualifications of EQC reviewers, such as failure to appoint persons with abilities corresponding to audit risks, as well as cases where EQC reviewers did not objectively review the sufficiency and appropriateness of audit evidence for significant audit items or the judgment process, and thus failed to identify significant deficiencies in audit procedures. In addition, deficiencies in the operation of EQC reviews were often identified as a result of analyzing the causes of deficiencies in individual audit engagements.

Causes of the identified deficiencies include the following issues:

- Due to reasons such as limitations in the personnel composition of the audit firm, an EQC reviewer with sufficient knowledge and experience corresponding to the audit risk as well as having spent enough time on reviews, was not assigned;

- In an audit firm where a small number of partners operate the business, the EQC reviewer did not spend sufficient time for the review putting a priority on the audit engagements he/she was in charge of;
- Although the audit firm did not have a sufficient number of partners or other staff members with sufficient knowledge and experience to perform the EQC review, the PICOQC did not examine whether persons with sufficient qualifications to serve as EQC reviewers had been hired or fostered. In addition, due to excessive trust placed in the EQC reviewer, the PICOQC did not aware of the need to develop an adequate review system;

The EQC reviewer only verified the same matters as the deficiencies identified in the CPAAOB inspections and quality control reviews, etc., and did not verify the status of responses to the same matters similar to the deficiencies in the course of the EQC review;

- As the engagement team did not pass on to the EQC reviewer (including in cases outsourced to an external EQC reviewer), in writing or by any other appropriate means, information regarding the condition of the audited company and the consideration of significant matters, the engagement team and the EQC reviewer did not share the recognition of risk and other audit matters; and
- The EQC reviewer assumed, from the daily communications with the engagement team, that the audit procedures performed by the team were sufficient and appropriate. Thus, the EQC reviewer did not examine the important judgments made by the engagement team and the sufficiency and appropriateness of their audit procedures through audit work papers. In addition, the EQC reviewer lacked awareness to critically examining engagement teams' opinions.

(Observed effective efforts)

The following is an example of an effective effort observed in an audit firm.

Besides the normal opinion engagement quality control review, the audit firm carried out preliminary engagement quality control reviews concerning important accounting estimates, such as the recoverability of deferred tax assets, at an early stage during the end-of-term audit, when the work of the engagement team and the EQC reviewer did not become hectic. As a result, engagement quality control reviews were performed with plenty of time and profound perspectives instead of being performed precipitously right before formulating audit opinions.

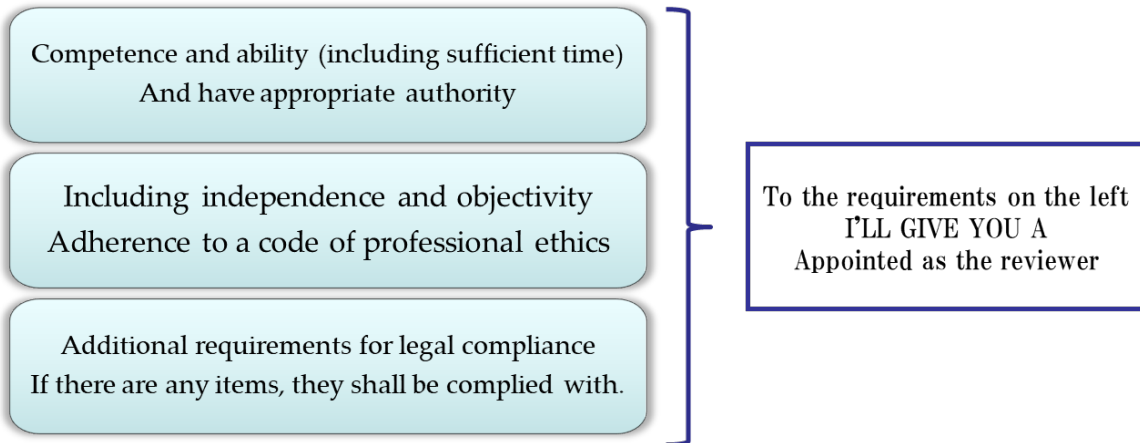
Expected response

When reviewing the audit planning, the EQC reviewer should review the risk assessment conducted and risk-related audit procedures planned by engagement teams from an objective perspective while taking into account not only audited companies' business activities and business performance trends but also business risks related to their business objectives and strategies.

In addition, the engagement team should discuss significant matters for forming the audit opinion with the engagement partner, but also review the audit documentation to determine whether the conclusions of the engagement team are supported by sufficient appropriate audit evidence. In particular, at some

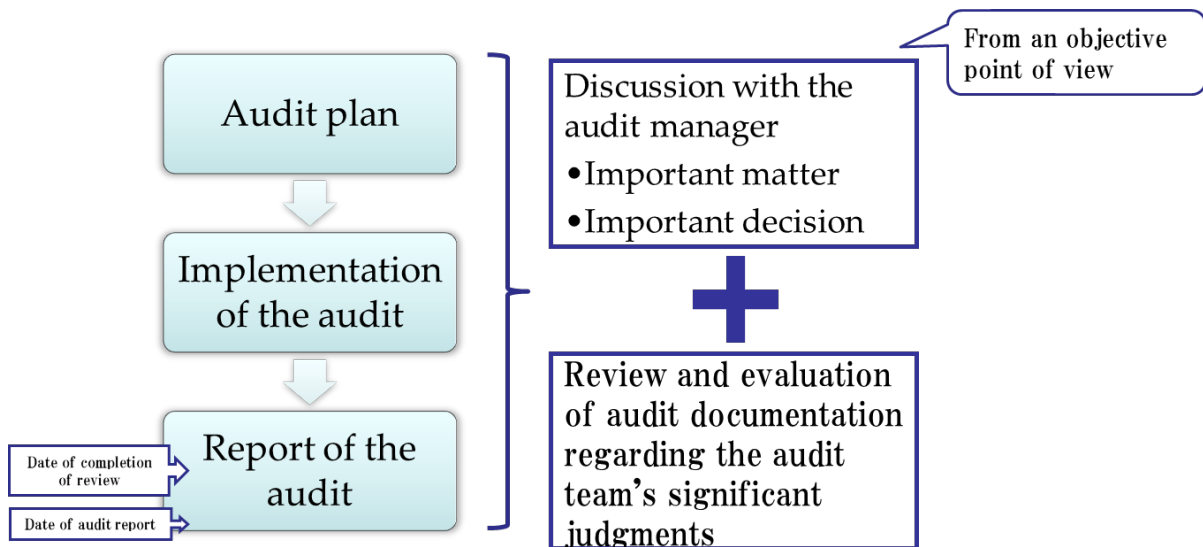
small and medium-sized audit firms, partners who are EQC reviewers are usually extremely busy because they are engaged in business operations with a small number of partners, and because they give priority to their own audit engagements, it is difficult to conduct appropriate EQC reviews. For this reason, it is necessary to take actions to enhance and strengthen EQC reviews while reaffirming the importance of EQC reviews of audit engagements. (see [Figures 6 and 7]).

Figure 6: Competency of Auditors



Source: Prepared by the CPAAOB based on data published by the JICPA

Figure 7: Procedures Performed by Auditors



Source: Prepared by the CPAAOB based on data published by the JICPA

Case 1: Eligibility of the EQC reviewer



In quality control reviews conducted by the JICPA, the audit firm continued to receive multiple deficiencies, some of which were significant, in audit engagements of audited companies under review.

However, the audit firm did not evaluate whether the EQCRer had the knowledge, experience, ability, etc. required to perform the role of an EQCRer, and did not examine the appropriateness of the EQCRer.

(QCSS No. 1, paragraphs 36, 37, and 38 (before amendment in 2022) ([Reference] QCSS No. 2, paragraphs 18 and 25), QCSS No. 220. paragraphs 19 and 20 (before amendment in 2022))

Case 2: Ensuring the effectiveness of EQCR



- ① In its Quality Control Rules, the audit firm stipulated that it should request an immediate review by the partners' meeting when it suspected a material misstatement due to fraud, when a material detection was not corrected, when a material matter was not finalized, when a material audit was not completed, when a material problem arose in the expression of an audit opinion, or when a material deficiency in internal controls that should be disclosed occurred.

However, although the EQCRer was aware that there was a material deficiency in the internal controls that should be disclosed, he / she did not request an EQCR by the partners' meeting.

(QCSS No. 1, paragraphs 36, 37, and 38 (before amendment in 2022) ([Reference] QCSS No. 2, paragraphs 18 and 25), QCSS No. 220, paragraphs 19 and 20 (before amendment in 2022))



- ② The EQCRer did not have sufficient understanding of the audit standards and the level of procedures required by the current audit standards, placed priority on the audit engagements for which he / she was the engagement partner, and did not allow sufficient time for the review. Therefore, the EQCRer concluded that there were no problems with the significant judgments and conclusions made by the engagement team and completed the review without sufficiently discussing with engagement partner and reviewing the related audit documentation regarding the fraud risk response, accounting estimates, and audit procedures for group audits, etc. that the engagement team had performed.

(QCSS No. 1, paragraphs 36 and 37 (revised in 2022) ([Reference] QCSCS No. 2, paragraph 25))

- ③ **The EQC reviewer assumed that the engagement team had appropriately responded to important matters that had been discussed in ongoing communication with the engagement team.** Therefore, the EQC reviewer concluded that there were no problems with the important judgments and conclusions made by the engagement team without fully examining the related audit documentation with respect to the evaluation of and responses to fraud risk and significant risks and important judgments on significant accounting estimates made by the engagement team.

(QCSS No. 1, paragraphs 36 and 37 (prior to the revision in 2022) [Reference] QCSS No.2, paragraph 25)

Case 3: Examination in the Financial Instruments and Exchange Act Audit

The engagement team did not inform the audited company that, at the time the audited company submitted its financial statements to EDINET, the response to consultations from the department in charge and the review of audit engagements had not been completed, and the firm was not in a position to make an official expression of its opinion; this led to the situation where the engagement team submitted the financial statements to EDINET that appeared as if the opinion had already been expressed, despite the fact that the EQC reviews had not been completed and the audited company's audit opinion was not yet expressed.

QCSCS No. 1, paragraphs 14 and 41 (before amendment in 2022) ([Reference] QCSS No. 2, paragraph 27), ASS No. 220, paragraph 17 (before amendment in 2022) ([Reference] QCSS No. 220, paragraphs 35 and 36))

《Points to Note》

The EQC reviewer needs to verify not only whether the accounting processes were suitable but also whether sufficient and appropriate audit evidence was obtained, and to make objective evaluations of engagement teams' explanations based on recorded facts by reviewing audit documentation.

In particular, with regard to audit engagements at regional offices, if the EQC reviewer at the headquarters, who is remotely located, conducts the EQCR via a videoconferencing system, etc., it is necessary to take actions such as sending the necessary audit documentation in advance.

The audit firm must also ensure that, even if it consigns an EQCR to a CPA outside the audit firm, the steps required to be taken are the same as assigning internal personnel to EQCR.

Furthermore, if the date of the audit report based on the Financial Instruments and Exchange Act is the same as the date on which the financial statements, etc. is submitted to EDINET, it is necessary to ensure sufficient communication with the audited company so that the financial statements, etc. is not submitted to EDINET before the examination is completed.

8. Monitoring the Firm's System of Quality Control Policies and Procedures

Points of focus

The monitoring of the SQM plays an important role in ensuring and improving audit quality as a process to voluntarily identify and understand issues relating to the SQM and to remediate such issues. For this reason, audit firms are required to perform ongoing monitoring of the SQM to ensure the appropriate establishment and implementation of policies and procedures relating to the SQM; and to perform periodic inspections of completed audit engagements in a specified period for each engagement partner. Furthermore, to confirm that an appropriate and adequate SQM has been established and is being implemented effectively, it is essential to accept statements of objection and doubt concerning violations of laws, regulations, and professional standards as well as breaches etc. of the SQM from inside and outside the audit firm. It is also necessary to conduct investigations based on this information, to take appropriate corrective action, as required, in the same way as in the case of deficiencies identified during ongoing monitoring and evaluations of the SQM.

In consideration of the above, the CPAAOB inspects whether monitoring of the SQM is effectively functioning from the following perspectives, in view of the importance of functions of SQM monitoring:

- ▶ Whether the audit firm assigns a person with sufficient and appropriate experience as the person responsible for the monitoring and improvement process of the system of quality control, and vests the assigned person with sufficient authority;
- ▶ Whether the audit firm sets up monitoring system which appropriately understands the status of the establishment and implementation of a quality control system and identifies deficiencies; and
- ▶ Whether the audit firm evaluates the impact of deficiencies identified in its daily monitoring activities, and takes appropriate improvement measures in accordance with the results of such evaluation.

The CPAAOB also inspects the implementation status of periodic inspections of audit engagements at audit firms from the following perspectives:

- ▶ Whether the audit firm ensures that the person in charge of periodic inspections performed in-depth inspections to confirm whether the audit evidence was sufficient and appropriate, for example, by making inquiries to audit teams and reviewing audit documentation, not only by superficial inspection using the checklist, etc.;
- ▶ Whether the audit firm selects target engagements for periodic inspections by sufficiently taking into account deficiencies in the audit procedures identified during the QC review, the CPAAOB's inspection or other occasions;
- ▶ Whether at least one completed audit engagement is selected for each engagement partner in each specified period determined by the audit firm as part of periodic inspections;
- ▶ Whether the audit firm analyzes the impact of deficiencies identified as a result of periodic inspections, has the relevant engagement partner take improvement measures, and verifies the appropriateness of such measures; and

- ▶ Whether the audit firm analyzes the deficiencies identified as a result of periodic inspections, and communicates the result of the analysis, together with corrective measures, throughout the firm.

The CPAAOB inspects Statements of objection and doubt from the following perspectives:

- ▶ Whether an appropriate system for a statements of objection and doubt has been established;
- ▶ Whether proper investigation is conducted based on the accepted statements; and
- ▶ Whether appropriate corrective action is taken in response to the results of investigations of statements of objection and doubt.

Outline of inspection results

As shown in the case example section below, there were deficiencies in the following areas: audit engagements of specific engagement partner were not subject to periodic inspection (including external persons responsible for those activities) conducted reviews based on checklists, etc. merely as a matter of formality and in which the PICOQC did not give those persons pre-inspection instructions or conduct post-inspection monitoring of them and there was a framework in which monitoring of the quality control system was performed by the CEO alone.. There were also many deficiencies concerning the operation of the quality control system, such as a failure to appropriately detect deficiencies regarding individual audit engagements in periodic inspections because the person in charge of inspection merely received explanations from engagement teams and failed to spend sufficient time on inspections.

The primary cause of those deficiencies was the audit firm's failure to allocate sufficient time and manpower to inspections due to a lack of sufficient understanding of the importance of monitoring the quality control system.

(Observed effective efforts)

The following is an example of observed effective efforts made by an audit firm.

- From the viewpoint of securing audit quality, the audit firm selects engagements subject to periodic inspection so that each engagement partner's work is inspected at a frequency of around twice every three years.
- In order to detect quality control issues in audit engagements at an early stage and enable audit firms to take systematic action, audit firms select audit engagements to be monitored based on the results of analysis of published financial statements and timely disclosure information, and the content of audit documentation is checked by a monitoring staff separate from the EQC reviewer by the date of the audit report required under the Companies Act.

Expected response

Audit firms are required to establish and implement an organizational system that adequately performs the primary function of quality control monitoring, which is to enable audit firms themselves to discover and understand problems related to the system of quality control and voluntarily implement remediation

measures. Specifically, audit firms required to identify individual audit engagements and items to be inspected, taking into account the size and industry of the audited company, the tenure and experience of the engagement partner, and give due consideration to the need to carefully select individual audit engagements and identify the necessary inspection items in light of the economic environment, the business condition of audited companies, and the results of the previous CPAAOB inspection or the quality control review. They also need to establish a system which ensures that qualified persons inspections conduct periodic inspections, rather than merely conducting superficial inspections based on the checklist, and to develop an environment to check the adequacy of the corrective measures taken against the deficiencies identified through inspections.

It should also be kept in mind that even when a CPA from outside the audit firm has been appointed as the person responsible for implementing periodic inspections, it is necessary to check whether the primary monitoring function is sufficiently exercised, just as it is when a person within the audit firm has been appointed to that post. Furthermore, it should be noted that, in the same way as when persons from within the audit firm are appointed, it is necessary to confirm whether the primary monitoring function is being fully exercised.

In addition, it is necessary to establish and implement a system which enables that statements of objection and doubt are recognized in a timely fashion, with appropriate investigations conducted as necessary. For example, one possible way to do that is to establish a system for receiving information from whistleblowers inside and outside the audit firm. It should also be noted that audit firms that conduct audit engagements that comply with the standards for responding to fraud risks at listed companies, etc., need to receive information relating to fraud risks that is provided to audit firms by sources inside and outside the firm.

Case 1: Effectiveness of ongoing monitoring



The audit firm did not consider the appropriateness of having the CEO, who was responsible for establishing the quality control system, assume the responsibility for day-to-day monitoring activities for the quality control system. Furthermore, the person responsible for the day-to-day monitoring activities for the quality control system did not report the results of the implementation of the day-to-day monitoring activities to the partners' meeting. Furthermore, the person responsible for the day-to-day monitoring activities for the quality control system merely confirmed the status of the establishment of rules, etc. as a formality, for example, determining that there were no problems with the existence of rules, etc. based on a checklist.

(QCSS No. 1, paragraphs. 47 and 52 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs. 36, 37, 39, 46, and 47))

Case 2: Effectiveness of periodic inspection

- ① **The persons in charge of periodic inspections merely conducted superficial checks based on the checklist without setting forth specific viewpoints of inspection and did not spend**

sufficient time on those checks. This resulted in a failure to conduct in-depth inspection from the viewpoint of whether engagement teams obtained sufficient and appropriate audit evidence.

Moreover, despite being aware that the time spent on inspections was short compared with the volume of the checklist and that the number of deficiencies identified was smaller than that of deficiencies identified in the quality control review, etc., the PICOQC did not evaluate the effectiveness of periodic inspections. In addition, the PICOQC did not develop a system to ensure the implementation of effective periodic inspections, for example by increasing the number of persons in charge of periodic inspections.

(QCSS No. 1, paragraphs. 47 and 48 (before amendment in 2022) [Reference] QCSS No. 1, paragraphs. 37, 38, 39, 40, and 41))

② The PICOQC did not sufficiently confirm the implementation records of periodic inspections in the past. Therefore, the PICOQC did not perform periodic inspections of audit engagements in which specific engagement partner were involved without specific reason.



(QCSS No. 1, paragraph 47 (before amendment in 2022) ([Reference] QCSS No. 1, paragraph 38))

《Points to Note》

In addition to the above cases, the following deficiencies have been identified,

- there were cases where persons were selected to carry out periodic inspection without consideration for their abilities with regard to audit quality, where a system was being implemented in a manner leading to collusion
- the monitoring of the quality control system was conducted solely by the CEO in some cases, while the frequency of periodic inspection of each audit engagements was too low in other cases.

From the perspective of analyzing deficiencies identified in the quality control review and preventing / discovering the identified deficiencies in advance, it is important to evaluate again whether periodic inspections were not limited to formal confirmation of the existence of audit documentation based on checklists, but were implemented effectively.

Case 3: Statements of objection and doubt

① Even though the representative partners received information about fraud at an audited company via a hotline, they **did not inform the PICOQC of the information they had obtained.**

Furthermore, even though the “Audit Quality Management Rules” stipulated that engagement partners in charge of audited companies should report how they considered whistleblowing from internal and external parties to the division in charge of quality control in writing, they did not make such reports.

(QCSS No. 1, paragraph F54-2 (before amendment in 2022) [Reference] QCSS No. 1, paragraph F34-4JP))

- ② However, the audit firm did not set up a contact point for accepting information related to fraud risk received from outside the firm, and **did not establish a specific system for responding to information related to fraud risk received from outside the firm.**
(QCSS No. 1, paragraphs 54, and F54-2 (before amendment in 2022) [Reference]QCSS No. 1, paragraphs 34, F34-4JP))

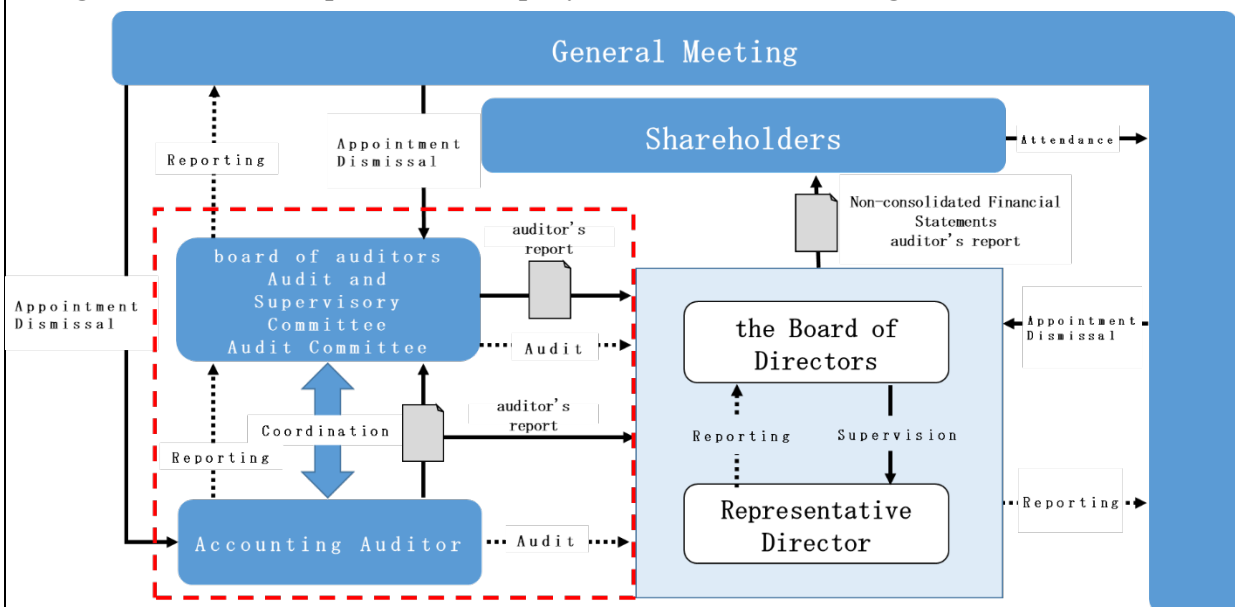
9. Cooperation with Company Auditors

(1) Communication between Accounting Auditors and Company Auditors

Points of focus

Accounting auditors and company auditors are obligated to ensure the appropriateness of financial statements under the Companies Act and applicable laws. To perform this obligation, it is important that they cooperate through actively exchanging information and opinions, for example, they should share information identified during audits in a timely manner, or company auditors should understand the status of QC of audits undertaken by accounting auditors. (Refer to [Figure 8])

[Figure 8] Relationship between Company Auditors and Accounting Auditors



Source: Prepared by the CPAAOB based on data published by the JICPA

In light of the importance of collaboration between accounting auditors and company auditors as described above, the CPAAOB inspects whether policies and procedures for communication with company auditors and responses when fraud, etc. is detected are appropriately established and implementation systems are developed and established from the following perspectives:

- ▶ Whether suitable provisions, requiring timely communication with company auditors at each phase of audits (planning, conducting, and reporting) and share of necessary information for enhancing both sides' audit work, have been stipulated;
- ▶ Whether a procedure in which, for example, basic forms and model sentences are prepared, has been put in place so that suitable explanations of the results of CPAAOB inspections and the results of quality control reviews are reported to audited companies in writing; and
- ▶ Whether the audit firm has properly established policies and procedures concerning responses to

non-compliance.

Inspection of communications with company auditors are carried out from the following perspectives:

- ▶ Whether communication with company auditors concerning the accounting auditor's responsibilities, the scope of the planned audit, and an overview of its timing is clearly being carried out;
- ▶ Whether explanations of the results of CPAAOB inspections and quality control reviews are suitably provided in writing to audited companies;
- ▶ Whether information on audits is being properly obtained from company auditors;
- ▶ Whether issues that are discovered during accounting audits and deemed to be important are conveyed in a timely manner to company auditors, etc. responsible for overseeing the financial reporting process; and
- ▶ Whether accounting auditors and company auditors cooperate and engage in effective two-way communication.
- ▶ Is there clear communication with company auditors about information related to compensation for audit engagements, which are business entities with a high degree of social impact?

Outline of inspection results

As the need for collaboration between accounting auditors and company auditors has been widely accepted among relevant persons, efforts have been made to develop and maintain an environment to facilitate communication between them. As a result, periodic communication has been promoted, although the depth of collaboration may vary case by case.

Audit firms are following the principle of reporting the results of the CPAAOB inspection or the quality control review to company auditors in writing in a timely manner. On the other hand, as shown in the example case section below, due to a lack of understanding of the items requiring communication, there were some cases in which communication was inadequate or in which audit firms, despite having received notification of the results of the quality control review from the JICPA, did not communicate the results to company auditors.

Expected response

The importance of cooperation between accounting auditors and company auditors has been recently emphasized again in response to the occurrence of fraudulent corporate financial reporting cases. The audit standards state, "the auditor must ensure appropriate cooperation, through consultation or otherwise, with company auditors at each stage of the audit."

ASS No. 260 ("Communication with Company Auditors) revised in February 2019 specifically seeks to enhance communication on particularly important matters when conducting audits, and it concretely manifests provisions on communication with company auditors, e.g., specifically describing the details to be conveyed to company auditors, regarding the results of quality control reviews and CPAAOB

inspections and disciplinary actions taken by regulatory authorities and JICPA, as well as the methods by which this information is to be conveyed, as part of explanations of the establishment and implementation of accounting auditors' quality control systems (Note 1, Note 2).

Accounting auditors need to improve the effectiveness of audits through information sharing with company auditors about every stage of the audit – from the audit planning to the implementation of audit procedures and the formation of an auditor's opinion – and significant circumstances identified in the process, exchange views on audit quality control issues highlighted in the results of CPAAOB inspections and quality control reviews, and actively promote collaboration with company auditors. This collaboration will help ensure and improve audit quality as well as enhance/strengthen corporate governance at audited companies.

In addition, the 2018 revision of auditing standards and related revisions to the Auditing Standards Report required the inclusion of Key Audit Matters ("KAM") in audit reports. KAM are to be determined from among those matters discussed between accounting auditors and company auditors and the introduction of KAM has made in-depth communication between accounting auditors and company auditors all the more important.

Furthermore, it should be noted that, pursuant to the revision of the Code of Ethics in July 2022, communication with company auditors is required regarding information related to compensation for audit engagements, which are entities with a high degree of social impact. Communication regarding information related to compensation includes matters related to audit fees and fees for non-audit engagements, as well as, in cases where the degree of dependence on fees exceeds 15%, details of the fact, the possibility that the situation will continue, and applicable safeguards.

Audit firms need to establish systems to support engagement teams so that engagement teams can suitably pursue effective two-way communication with company auditors.

(Note 1) Disclosure of the results of the CPAAOB inspection to a third party needs the advance approval of the CPAAOB, in principle. However, no advance approval of the CPAAOB is necessary if the disclosure is made to those charged with the governance or equivalent of the audited company and the disclosed information is “whether or not there were deficiencies in the establishment or implementation of the quality control system of the audit firm and the outline of such deficiencies” or “whether or not there were deficiencies related to the engagement for the audited company and the outline of such deficiencies.”

(Please refer to "III. Handling of Inspection Results" in the "Basic Policy for Inspections Performed by the Certified Public Accountants and Auditing Oversight Board" published on the CPAAOB's website)

(Note 2) In principle, any disclosure, including whether or not the audit firm is being inspected by the CPAAOB, is not permitted during the inspection.

Case: Communication with company auditors

- ① The engagement partner did not sufficiently understand the audit standards pertaining to communication with company auditors and thus **did not convey to company auditors the contents of and the steps taken in response to the “Quality Control Review Report” and the “Follow-up Review Report” received from JICPA** that are very useful for company auditors when selecting accounting auditors.

(ASS No. 260, paragraphs 16 and A31)



- ② The engagement team did not communicate sufficiently with the company auditors, as it failed to provide reports on the following matters:

- **Uncorrected misstatements which came to light after the issuance of the audit report on the Companies Act audit;**
- **The draft of the written representations by the auditor in an audit under the Financial Instruments and Exchange Act.**

(ASS No. 260, paragraph 13 and 14; No. 600, paragraph 48; and No. 610, paragraph 16)

《Points to Note》

Auditor should keep in mind that they must communicate with company auditors on matters required in the ASS in a timely basis. For example, the timing of communication regarding the draft of the written representations and communication regarding independence should be determined based on measures that company auditors are expected to take. In addition, if there are any changes in the audit plan, such as changes in significant risks during the term, or any changes in matters communicated with company auditors, such as uncorrected misstatements discovered after the issuance of the Companies Act Audit Report, it is necessary to communicate with company auditors again in a timely manner. Furthermore, when conducting both Financial Instruments and Exchange Act audits and Companies Act audits of audited companies, the scope of audits and the date of the audit report differ. Therefore, even at the final stage of Financial Instruments and Exchange Act audits, it is necessary to communicate with company auditors on matters required in the ASS such as draft management agreements and the results of internal control audits. It should be kept in mind that when communicating verbally with company auditors, the auditor must record in the audit documentation when, with whom, and on what topics the communication was conducted.

(2) Response to Detection of Fraud/ Non-Compliance

Points of focus

In the event of discovering any fact that may affect ensuring the appropriateness of financial statements (a fact such as a violation of laws and regulations) of the audited company, the auditor is obligated to notify company auditors thereof so as to encourage the audited company to implement voluntary

corrective action (see Article 193-3 of the Financial Instruments and Exchange Act). In light of the importance of such notice for ensuring the appropriateness of financial statements, the CPAAOB inspects the status of how the audit firm responded to the detection of fraud or non-compliance.

Outline of inspection results

(Observed effective efforts)

The following is an example of an effective effort observed in an audit firm.

Thoroughgoing efforts are being made to familiarize partners, etc., e.g., examples of notifications to be sent to company auditors of audited companies when facts of a non-compliance have been discovered are being presented.

Additionally, as a result of the audit firm having provided notice to the entity in accordance with Financial Instruments and Exchange Act Article 193-3 about matters that could adversely impact the appropriateness of financial documents, the entity revised its Financial statements and sought to reinforce its systems for suitable disclosure.

Expected response

It should be kept in mind that in the event of detecting any deficiency during an audit that may affect the appropriateness of financial statements, audit firms should respond to such deficiency by facilitating audited companies to make corrections, including considering whether to give notice under Article 193-3 of Financial Instruments and Exchange Act.

A support system for engagement teams must also be established so that experts are able to provide appropriate opinions when audit judgments about fraud or non-compliance are made.

Please refer to "Practical Guidelines for Audits of Financial Statements Included in Amendment Reports" (revised in September 2024), ASS 560, Practical Guidelines No. 2, published by the JICPA, for points to be noted in order for auditors to take appropriate actions in audits of amended financial statements included in amendment reports for financial statements, interim reports, and quarterly reports.